New Developments Summary

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NDS 2020-08

Reference rate reform

ASUs simplify accounting for transition from LIBOR and certain other reference rates

Contents

In March 2020, January 2021, and December 2022, the FASB issued ASUs 2020-04, 2021-01, and 2022-06, respectively, to simplify the accounting for contract modifications made to replace LIBOR or other reference rates that are expected to be discontinued because of reference rate reform. The guidance provides optional expedients and exceptions for applying U.S. GAAP to these contract modifications if certain criteria are met. The optional expedients and exceptions can be applied to contract modifications made until December 31, 2024.

A. Overview

Regulators in various jurisdictions around the world have undertaken reference rate reforms to identify interest-rate benchmark rates that are more observable or transaction-based, and therefore less susceptible to manipulation, than certain interest-rate benchmark reference rates that are commonly used currently, including the most prominent of them all, the London Interbank Offered Rate (LIBOR). Most regulators have agreed to phase out the old rates by June 30, 2023. The discontinuation of benchmark reference rates will require entities to modify contracts that use those rates by removing the old rates and including new rates.

In March 2020, the FASB issued ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting,* which, for a limited period of time, adds a new Topic to U.S. GAAP, ASC 848, *Reference Rate Reform,* to provide entities with certain practical expedients and exceptions from applying modification accounting in various ASC Topics if certain criteria are met. The ASU is designed to reduce operational challenges that entities will face in applying modification accounting to all the contracts that will be revised due to reference rate reforms.

In January 2021, the FASB issued ASU 2021-01, *Reference Rate Reform (Topic 848): Scope*, which clarifies that changes to interest rates used for discounting, margining, and contract price alignment for derivative instruments due to reference rate reform are within the scope of ASC 848.

In December 2022, the FASB issued ASU 2022-06, *Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848*, which deferred the sunset date of ASC 848 from December 31, 2022 to December 31, 2024. Those amendments were made in response to a key regulator announcing that the intended cessation date of several USD LIBOR tenors would be June 30, 2023 instead of December 31, 2021.

The guidance in ASC 848 will not apply to any contract modifications made after December 31, 2024 or to any hedging relationships entered into or evaluated after December 31, 2024, except for those hedging relationships existing as of December 31, 2024 for which an entity has elected certain optional expedients that are retained through the end of the hedging relationship.

B. Scope (ASC 848-10)

The guidance in ASC 848 is elective and applies to contracts and other transactions that reference LIBOR or other reference rates that are expected to be discontinued as a result of reference rate reform.

A reference rate is expected to be discontinued if any one of the following three conditions exists:

- The reference rate administrator or its regulatory supervisor has announced its intention to discontinue the reference rate.
- A significant number of market participants (or market participants representing a significant number of transactions) take the initiative to move away from the reference rate.
- The method to calculate the reference rate is either fundamentally restructured or relies on another rate that is expected to be discontinued.

Entities may also elect to apply certain guidance in ASC 848 to modifications of derivatives that do not reference a rate expected to be discontinued, but are amended to change a rate for discounting, margining, or contract price alignment, provided that the rate is modified because of reference rate reform. Changes to rates for discounting, margining, and contract price alignment due to reference rate reform are referred to as the “discounting transition.”

“Discounting” refers to the process of calculating the fair value of a contract based on the present value of the contract’s future cash flows using a discount rate, which, in many cases, is a specified interest rate index.

“Margining” refers to the process whereby entities exchange payments to collateralize a contract. In many cases, margin requirements are a function of the contract’s fair value, which, as described above, may be calculated using a specified interest rate index.

“Contract price alignment” refers to interest accrued on margin payments posted to collateralize a contract, which may be calculated based on a specified interest rate index.

Regardless of whether the rate used for discounting, margining, or contract price alignment is a rate that is being discontinued due to reference rate reform, if the affected instrument is a derivative and the rate is changed due to reference rate reform, that derivative may be within the scope of ASC 848.

C. Sale or transfer of held-to-maturity debt securities (ASC 848-10)

An entity may make a one-time election between March 12, 2020 (the date when ASU 2020-04 was issued) and December 31, 2024 to sell a debt security classified as held-to-maturity or to reclassify the debt security as available-for-sale or trading if the debt security meets both of the following criteria:

- The security includes a reference rate within the scope of ASC 848.
- The security was classified as held-to-maturity before January 1, 2020.

Any sale or transfer of held-to-maturity debt securities in accordance with the guidance in ASC 848 will not impact the entity’s assertion regarding its intent and ability to hold the remaining debt securities classified as held-to-maturity. Any transfer should be recognized as of the date when the entity makes the transfer decision and should be measured in accordance with the guidance on debt and equity security investments in ASC 320-10-35-10 through 35-16, which requires an entity to measure the transferred security at fair value. The unrealized gain or loss at the date of transfer is recognized in earnings if the transfer is to trading classification or in other comprehensive income or if the transfer is to available-for-sale classification.

For any sale or transfer of a held-to-maturity security in accordance with the guidance in ASC 848, an entity should disclose the following information:

- The net carrying amount of the sold or transferred security
- The net gain or loss in accumulated other comprehensive income for any derivative that hedged the forecasted acquisition of the held-to-maturity security
- The related realized or unrealized gain or loss
- The circumstances leading to the decision to sell or transfer the security

D. Contract modifications (ASC 848-20)

Scope

The guidance in ASC 848-20 is elective and applies only to a contract modification that

- Replaces LIBOR or a reference rate that is expected to be discontinued as a result of reference rate reform (including rates referenced in “fallback” provisions, which mandate when a change in reference rate is needed and what new rate should be used).
- Modifies contract terms that would or do change the amount or timing of contractual cash flows, and is related to the replacement of LIBOR or another reference rate that is expected to be discontinued as a result of reference rate reforms (including adding or changing fallback provisions).
- Does not change the amount or timing of contractual cash flows (except for modifications due to the discounting transition) but is made contemporaneously with modifications related to reference rate reform.

The guidance in ASC 848-20 also applies to derivative modifications due to the discounting transition (that is, derivatives for which the interest rate used for discounting, margining, or contract price alignment is changed because of reference rate reform).

The election to apply the guidance in ASC 848-20 to derivative modifications due to the discounting transition is separate from the election to apply that guidance to other contracts, including derivatives, affected by reference rate reform.

The guidance in ASC 848-20-15-5 through 15-6 provides examples of contract modifications that are considered either related or unrelated to reference rate reform.

Identifying Changes to Terms Related and Unrelated to the Replacement of the Reference Rate

ASC 848-20-15-5

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 and are not the result of a business decision that is separate from or in addition to changes to the terms of a contract to effect that transition. Examples of changes to terms that are related to the replacement of a reference rate in accordance with the guidance in paragraph 848-20-15-2(a) include the following:

a. Changes to the referenced interest rate index (for example, a change from London Interbank Offered Rate [LIBOR] to another interest rate index)

b. Addition of or changes to a spread adjustment (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 for any difference 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, payment frequency, and repricing calculation (for example, a change from a forward-looking term rate to an overnight rate or a compounded overnight rate in arrears)

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

e. Addition of an interest rate floor or cap that is out of the money on the basis of the spot rate at the time of the amendment of the contract

f. Addition of a prepayment option for which exercise is contingent upon the replacement reference interest rate index not being determinable in accordance with the terms of the agreement

g. Addition of or changes to contractual fallback terms that are consistent with fallback terms developed by a regulator or by a private-sector working group convened by a regulator

h. Changes to terms (including those in the examples in paragraph 848-20-15-6) that are necessary to comply with laws or regulations or to align with market conventions for the replacement rate.

ASC 848-20-15-6

Examples of changes to terms that are generally unrelated to the replacement of a reference rate in accordance with paragraph 848-20-15-3 include the following:

a. Changes to the notional amount

b. Changes to the maturity date

c. Changes from a referenced interest rate index to a stated fixed rate

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

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

f. The addition of an interest rate floor or cap that is in the money on the basis of the spot rate at the time of the amendment of the contract

g. A concession granted to a debtor experiencing financial difficulty.

In connection with modifying a contract, an entity might add or amend contractual fallback terms. If the new fallback terms are consistent with those developed by a regulator or by a private-sector working group convened by a regulator, then the addition or amendment of the fallback terms is presumed to be related to reference rate reform. If the new fallback terms are inconsistent with those developed by a regulator or by a private-sector group convened by a regulator, then an entity should assess whether the new terms include, or have the potential to include, a term that is unrelated to reference rate reform in determining whether the modification is within the scope of ASC 848.

A contract modification that replaces a reference rate index with a stated fixed rate is unrelated to reference rate reform. However, a replacement rate that is equal to the last published rate of a discontinued interest-rate index is not a stated fixed rate (that is, the replacement can be considered related to reference rate reform).

Accounting for in-scope contract modifications

The election to apply the guidance in ASC 848-20 to contract modifications should be applied to all contract modifications that are accounted for within the scope of an ASC Topic or industry Subtopic. For example, if an entity elects to account for modifications to lease contracts within the scope of ASC 842, *Leases* (ASC 840 prior to the adoption of ASU 2016-02) in accordance with ASC 848-20, then all lease contract modifications within the scope of ASC 848-20 will be subject to the guidance in ASC 848-20.

The election to apply the relevant guidance in ASC 848-20 to derivative modifications due to the discounting transition should be applied to all such derivative modifications.

The new guidance allows entities to prospectively account for contract modifications within the scope of ASC 848-20. Therefore, such modifications will not require entities to remeasure the modified contract at the modification date or to reassess a prior accounting conclusion.

The following table shows a summary of expedients under ASC 848 by Codification topics.

ASC Topic	Expedient under ASC 848
ASC 310, *Receivables*	The modification is considered minor in accordance with ASC 310-20-35-10 and the effective interest rate is adjusted prospectively.
ASC 470, *Debt*	The modification is considered not substantial and is accounted for prospectively by adjusting the effective interest rate in accordance with ASC 470-50.
ASC 842 and ASC 840, both titled *Leases*	The modification does not require lessees or lessors to reassess lease classification and the discount rate, to remeasure lease payments, or to make other reassessments or remeasurements that are required for a contract modification that is not accounted for as a separate contract. The lease is accounted for as a continuation of the existing lease.
ASC 815-15, *Derivatives and Hedging: Embedded Derivatives*	The modification does not require entities to reassess whether the contract contains an embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract under ASC 815-15-25-1(a).
ASC 815-10, *Derivatives and Hedging: Overall*	The modification does not require entities to reassess whether the modified instrument is a hybrid instrument and whether it includes a financing element (ASC 815-10-45-11 through 45-15). The post-modification instrument continues to be accounted for and presented in the same manner as the pre-modification instrument.
ASC 944, *Financial Services – Insurance*	The modification does not require entities to reassess whether the contract is substantially unchanged in accordance with ASC 944-30. The post-modification contract continues to be accounted for and presented in the same manner as the pre-modification contract.
ASC 606, *Revenue from Contracts with Customers*	The modification does not require entities to apply the contract modification guidance in ASC 606-10-25-10 through 25-13.

ASC Topic	Expedient under ASC 848
	The change in cash flows resulting from variability in the new reference rate is accounted for in the same manner as the variability that resulted from the original reference rate.
ASC 810, *Consolidation*	The modification is not a reconsideration event and, therefore, does not require a reporting entity to reconsider whether the counterparty to the contract is a variable-interest entity.

E. Hedging (ASC 848-30)

The new guidance allows the following optional expedients for different types of hedging relationships, which entities will generally elect on a hedge-by-hedge basis:

- *For all types of hedging relationships (that is, fair value hedges, cash flow hedges, and net investment hedges):*
  - The hedging relationship may continue without dedesignation of the hedging relationship if changes to the contractual terms of the hedging instrument, the hedged item, or the forecasted transaction are made due to reference rate reform (or, for derivatives, due to the discounting transition).
  - If a component that is affected by reference rate reform is excluded from the assessment of hedge effectiveness, the entity can change the systematic and rational method used to recognize the excluded component in earnings. In addition, if the changes to a hedging instrument's contractual terms change the fair value of the excluded component, that change in fair value may be recognized in current earnings in the same income statement line item used to present the earnings' effect of the hedged item.
- *For a cash flow hedge:* A change to the method of assessing hedge effectiveness documented at hedge inception would not require dedesignation of the hedging relationship if both (1) the hedging instrument, hedged item, or hedged transaction references LIBOR or another rate that is expected to be discontinued, and (2) the new method designated for assessing hedge effectiveness is an optional expedient specified in ASC 848-50.
- *For a fair value hedge:* A change to either the proportion of a designated hedging instrument or the proportion of the hedged item would not require dedesignation of the hedging relationship.
- *For a net investment hedge:* A change to the repricing intervals and dates such that they differ for each leg of a designated receive-variable, pay-variable cross-currency interest rate swap would not require dedesignation of the hedging relationship.
- *For fair value and cash flow hedges:* A change to the designated hedging instrument to combine and jointly designate two or more derivative instruments or proportions of those instruments in a hedging relationship would not require dedesignation of the hedging relationship.

F. Fair value hedges (ASC 848-40)

The new guidance allows the following optional expedients, which can be individually elected on a hedge-by-hedge basis for fair value hedging relationships if the hedging instrument or hedged item includes a rate that is expected to be discontinued due to reference rate reform (or if a derivative hedging instrument is affected by the discounting transition):

- A change to the designated benchmark interest rate that is expected to be impacted by reference rate reform to a different eligible benchmark interest rate under ASC 815-20, or a change to the rate used for discounting, margining, or contract price alignment in a derivative that is affected by the discounting transition, would not require dedesignation of the hedging relationship if the hedge is expected to be highly effective. The guidance permits an entity to apply a method to change the designated benchmark interest rate that either adjusts the hedged item's cumulative fair value hedge-basis adjustment or maintains the cumulative basis adjustment. If the approach elected results in a change to the cumulative fair value hedge-basis adjustment, that change should be recognized in current earnings in the same income statement line item where the hedged item's effect on earnings is presented. The method applied to change the designated benchmark interest rate should be applied consistently across similar fair value hedging relationships.
- Entities that apply fair value hedge accounting using the shortcut method for assessing hedge effectiveness may disregard certain conditions for applying the shortcut method in determining whether a hedge continues to qualify for the shortcut method when certain changes are made to the contractual terms of the hedging instrument.

G. Cash flow hedges (ASC 848-50)

The guidance allows the following optional expedients, which can be individually elected on a hedge-by-hedge basis for cash flow hedging relationships if the hedging instrument or hedged item includes a rate that is expected to be discontinued due to reference rate reform:

- Entities may disregard changes in the designated hedged interest rate risk when assessing whether the hedged forecasted transaction is probable, and may continue to apply hedge accounting if either the hedge remains highly effective or the entity elects to apply an optional expedient to subsequently assess hedge effectiveness under ASC 848-50-35.
- Entities may make certain adjustments to the quantitative methods of assessing hedge effectiveness described in ASC 815-30-35-10 through 35-32.
- An entity may make certain adjustments to the critical terms of a perfectly effective hypothetical hedging instrument to match the hedging instrument when assessing effectiveness based on an option's terminal value in accordance with ASC 815-20-25-126.
- For cash flow hedges of portfolios of forecasted transactions, an entity may disregard the requirement that the group of individual transactions must share the same risk exposure for which they are designated as being hedged.

In situations where either (1) the hedging instrument or hedged item includes a rate that is expected to be discontinued due to reference rate reform, or (2) a derivative hedging instrument is affected by the discounting transition, entities may disregard certain conditions for

- Determining whether a cash flow hedge qualifies for the shortcut method to assess hedge effectiveness

- Determining the presumption of perfect effectiveness when an option's terminal value is used in assessing hedge effectiveness
- Applying the simplified hedge accounting approach for eligible private companies
- Determining the presumption of perfect effectiveness in applying the change-in-variable cash flows method and the hypothetical derivative method

H. Effective date and disclosures

Contract modifications

Guidance in ASU 2020-04

An entity may elect to apply the amendments in ASU 2020-04 as of any date from the beginning of the interim period that includes or is subsequent to March 12, 2020, or it may apply the guidance prospectively from a date within an interim period that includes or is subsequent to March 12, 2020, up to the date when the financial statements are available to be issued.

Guidance in ASU 2021-01

An entity may elect to apply the amendments in ASU 2021-01 retrospectively as of any date from the beginning of an interim period that includes or is subsequent to March 12, 2020, or it may apply the guidance prospectively from a date within an interim period that includes or is subsequent to January 7, 2021, up to the date when the financial statements are available to be issued.

Hedge accounting

The guidance related to hedges may be applied to eligible hedging relationships that either existed on, or were entered into after, the beginning of the interim period that includes March 12, 2020 (that is, January 1, 2020 for a calendar-year entity).

If an entity has not adopted the amendments in ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, it is eligible to apply only certain of the optional expedients provided in ASC 848 for hedging relationships.

Sunset provision

The guidance in ASC 848 may not be applied to contract modifications made after December 31, 2024 or to new hedging relationships entered into after that date.

In addition, the new guidance may not be applied to hedging relationships for periods after December 31, 2024, although hedging relationships existing at December 31, 2024 that apply the following expedients should retain those expedients through the end of the hedging relationship:

- Expedient used to recognize in earnings the components excluded from the assessment of effectiveness in ASC 848-30-25-12
- Expedient used to determine the rate to discount cash flows associated with the hedged item, as well as expedient used for any adjustment to the cash flows for the designated term or the partial term of the designated hedged item in a fair value hedge, in ASC 848-40-25-6
- Expedient used to not periodically evaluate the conditions in ASC 815-20-25-104(d) and (g) when using the shortcut method for a fair value hedge in ASC 848-40-25-8

Disclosures

Entities should disclose the nature of the optional expedients applied and the reasons for electing the optional expedients in the annual financial statements and in each interim period within the fiscal period of adoption.

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