IBOR reform – Phase 2 final amendments issued

27 August 2020

Chris Spall
Partner
KPMG in the UK

Targeted accounting relief to ease adoption of a new benchmark rate

Highlights

- The story so far…
- Practical expedient for modifications
- Specific relief from discontinuing hedging relationships
- New disclosures will apply
- Amendments apply retrospectively from 1 January 2021
- Next steps – Listen to our podcast

Many companies use benchmark interest rates – e.g. in their loan instruments, lease contracts and in hedge accounting. The replacement of some of these rates with alternative benchmark rates is expected to be mostly complete by the end of 2021. To ensure that financial statements best reflect the economic effects of IBOR reform, the International Accounting Standards Board (the Board) has issued amendments[1] that focus on the accounting once a new benchmark rate is in place.

The story so far…

IBOR reform refers to the global reform of interest rate benchmarks, which includes the replacement of some interbank offered rates (IBOR) with alternative benchmark rates. The Board identified two groups of accounting issues arising from IBOR reform that could affect financial reporting and divided its **project**, *IBOR Reform and its Effects on Financial Reporting*, into two phases:

- pre-IBOR reform: where uncertainty could arise in the run-up to transition (Phase 1 amendments); and
- post-IBOR reform: when that uncertainty goes away but companies update the rates in their contracts and the details of their hedging relationships (Phase 2 amendments).

The Phase 2 amendments principally address the following issues.

1. Interest Rate Benchmark Reform—Phase 2: Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16

Despite the COVID-19 pandemic, the Board has completed its project on the financial reporting impacts arising from global reform of benchmark interest rates. These amendments aim to reduce the accounting 'noise' surrounding the change to an alternative benchmark rate. Allowing companies to account for this change as a continuation of a hedging relationship, for example, will not only provide welcome practical relief but also better reflect the economic effects of the reform.

Chris Spall,
KPMG global IFRS financial instruments leader

Practical expedient for modifications

Under the detailed rules of IFRS 9 *Financial Instruments*, modifying a financial contract can require recognition of a significant gain or loss in the income statement. However, the amendments introduce a practical expedient if a change results directly from IBOR reform and occurs on an 'economically equivalent' basis. In these cases, changes will be accounted for by updating the effective interest rate.

A similar practical expedient will apply under IFRS 16 *Leases* for lessees when accounting for lease modifications required by IBOR reform.

Specific relief from discontinuing hedging relationships

The amendments also allow a series of exemptions from the regular, strict rules around hedge accounting. See our **summary of the amendments** for details. For example, a company will not need to discontinue existing hedging relationships because of changes to hedge documentation required solely by IBOR reform. Therefore, when a hedged risk changes due to benchmark reform, a company may update the hedge documentation to reflect the new benchmark rate and the hedge may be able to continue without interruption.

However, similar to the Phase 1 amendments, there is no exception from the measurement requirements that apply for the hedged items and hedging instruments under IFRS 9 or IAS 39 *Financial Instruments: Recognition and Measurement*. Once the new benchmark rate is in place, the hedged items and hedging instruments are remeasured based on the new rate and any hedge ineffectiveness will be recognised in profit or loss.

New disclosures will apply

So that users of financial statements can understand the effect of the reform on a company's financial instruments and risk management strategy, a company will need to provide additional information about:

- the nature and extent of risks to which the company is exposed arising from financial instruments subject to IBOR reform and how it manages those risks; and
- the company's progress in completing its transition to alternative benchmark rates and how it is managing that transition.

Amendments apply retrospectively from 1 January 2021

The amendments apply retrospectively with earlier application permitted. Hedging relationships previously discontinued solely because of changes resulting from the reform will be reinstated if certain conditions are met.

Next steps

See our **summary of the amendments** to find out more about the relief. For more on the amendments and their particular impact for corporates, listen to our **podcast** and visit **home.kpmg/IBORreform** to keep up to date with the latest news and discussion.

IBOR reform – Phase 2 amendments

Summary

Area	Amendments
Modification of a financial asset or a financial liability	– IBOR reform will generally result in a change in the basis for determining the contractual cash flows of that financial asset or financial liability. – As a practical expedient, a company will apply paragraph B5.4.5 of IFRS 9 to account for a change in the basis for determining the contractual cash flows of a financial asset or financial liability that is required by IBOR reform – i.e. update the effective interest rate of the financial asset or financial liability. For this purpose, a change is required by IBOR reform if the following conditions are met. - The change is *necessary as a direct consequence* of the reform. - The new basis for determining the contractual cash flows is *economically equivalent* to the previous basis (i.e. the basis immediately before the change). – If there are other changes to the basis for determining the contractual cash flows, then a company first applies the practical expedient to the changes required by IBOR reform and then other applicable requirements of IFRS 9. – An insurer applying IAS 39 will also apply amendments similar to the above.
Modification of a lease	– A lessee will apply paragraph 42 of IFRS 16 as a practical expedient to account for a lease modification that is required by IBOR reform – i.e. when remeasuring the lease liability, it will use a revised discount rate that reflects the change in interest rate.
Additional reliefs for hedging relationships	– When a company ceases to apply the IBOR Phase 1 amendments to a hedging relationship, it will apply the following exceptions to the hedging relationship. - The company will amend the formal designation of a hedging relationship to reflect the changes that are required by the reform. This change needs to be made by the end of the reporting period and will not result in a discontinuation of the hedge or designation of a new hedging relationship. - When a hedged item in a cash flow hedge is amended to reflect the changes that are required by the reform, the amount accumulated in the cash flow hedge reserve will be deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined. A similar exception is also provided for a discontinued cash flow hedging relationship. - When a group of items is designated as a hedged item and an item in the group is amended to reflect the changes that are required by the reform, a company will allocate the hedged items to sub groups based on the benchmark rate being hedged, and designate the benchmark rate for each sub-group as the hedged risk. A company will assess each sub-group separately to determine whether the sub-group is eligible as a hedged item. However, all other hedge requirements are applied to the hedging relationship in its entirety. - If a company reasonably expects that an alternative benchmark rate will be separately identifiable within a period of 24 months, it can designate the rate as a non-contractually specified risk component even if it is not separately identifiable at the designation date. This is applied on a rate-by-rate basis and also applicable to a new hedging relationship. - When performing a retrospective hedge effectiveness assessment under IAS 39, a company may reset the cumulative fair value changes of the hedged item and hedging instrument to zero immediately after ceasing to apply the Phase 1 relief on a hedge-by-hedge basis.

New disclosures	– To enable users of financial statements to understand the effect of IBOR reform on a company's financial instruments and risk management strategy, a company will need to provide additional disclosures on: - how it is managing its transition to alternative benchmark rates, including information on the risks and its transition progress at the reporting date; - quantitative information about financial instruments indexed to rates subject to benchmark reform at the end of the reporting period, disaggregated by significant interest rate benchmark; and - the extent to which IBOR reform has resulted in changes to a company's risk management strategy and how the company is managing those risks.
Effective date and transition	– The amendments are applied for annual periods beginning on or after 1 January 2021 with earlier application permitted. – A company applies the amendments retrospectively, except that it will reinstate a discontinued hedging relationship if the following conditions are met. - The hedging relationship was discontinued solely due to changes required by IBOR reform and if the amendments had been applied at that time it would not have been required to discontinue that hedging relationship. - At the date of initial application of the amendments, that discontinued hedging relationship continues to meet all qualifying criteria for hedge accounting. – In addition, a company is not required to restate prior periods to reflect the application of the amendments. However, the company may restate prior periods if it is possible without the use of hindsight.

Publication name: *IBOR reform – Phase 2 final amendments issued*

Publication date: September 2020

home.kpmg/ifrs