FINANCIAL SERVICES TRENDS

LIBOR TRANSITION: THE FINANCIAL ACCOUNTING STANDARDS BOARD'S (FASB) GUIDANCE TO SUPPORT A SMOOTHER TRANSITION

BY LAURENCE KARAGULIAN AND ARTHUR MIDIANGA

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As the transition away from LIBOR and other interbank offered rates as a benchmark rate at the end of 2021 draws closer, impacting trillions of dollars of financial transactions, the FASB released temporary optional guidance to ease the accounting impact related to the Reference Rate Reform.

On March 12, 2020, the FASB issued an Accounting Standards Update (ASU) *Accounting Standards Update 2020-04 Reference Rate Reform (Topic 848)* which provides optional expedients and exceptions for applying generally accepted accounting principles (GAAP) to :

- Contracts modifications,
- Hedging relationships, and
- Other transactions affected by reference rate reform, based upon specific criteria.

This ASU would allow firms with significant exposure to LIBOR to better face key challenges related to the volume of instruments (contracts and other arrangements, such as debt agreements, lease agreements, and derivative instruments) which will be impacted by this transition.

Potential operational challenges impacting the LIBOR transition include:

- Elevated costs due to a compressed timeframe for contract modification.
- Financial reporting results need to reflect intended continuation of contracts and arrangements during the period of market-wide transition.
- Disallowing the application of certain hedge accounting guidance and certain hedge relationships may not qualify as *highly effective* during the period of market-wide transition to a replacement rate.
- Financial reporting outcomes that don't reflect intended hedging strategies may occur due to the inability to apply hedge accounting.

Guidance Under ASU 2020-04

To address concerns, the FASB guidance allows for entities to elect the following:

	Application
1. Simplification of accounting analysis under current GAAP for **contract modifications**	Change applies to: • Modifications of loans and debt are accounted for by prospectively adjusting the effective interest rate. Do not require re-assessment: • Modification of loan & lease classification or re-measurement of lease payments that would otherwise be required by GAAP. • Contracts where an embedded derivative should be accounted for as a separate instrument. • Modifications of contracts, where explicit relief is not stated are not considered an event requiring contract re-measurement of a previous accounting determination.
2. Allow **hedging relationships** to continue with designation upon following changes in critical terms of existing hedging relationship due to reference rate reform.	Change applies to: • Critical terms of designated hedging instruments at fair value hedge, cashflow hedge, or net investment hedge. • Re-balancing or adjustment of hedging relationships. • The change in method used for cash flow hedges to assess the hedge effectiveness when initially applying optional expedient methods when reverting to GAAP requirements.
3. Allow change in systematic and rational method used to recognize in earnings the components excluded from the assessment **hedge effectiveness**.	Change applies to: • Fair value hedging relationships, cash flow hedging relationship, and net investment relationships excluded from the assessment of hedge effectiveness.
4. Provide optional expedients for **fair value hedging relationships** for fair value hedging instrument affected by reference reform.	For fair value hedging relationships, an entity may: • Change the designated benchmark interest rate documented at hedge inception to a different eligible benchmark interest rate. • Disregard certain qualifying conditions for the shortcut method not met due to reference rate reform for the remainder of the hedging relationship.
5. Provide optional expedients for **cash flow hedging relationships** affected by reference reform.	For cash flow hedging relationships, an entity may: • When assessing whether a hedged forecasted transaction will probably continue, disregard the potential change in the designated hedged interest rate risk that may occur due to Libor reform. • Continue to apply shortcut methods or methods assuming "perfect hedge" effectiveness, where applicable. • Adjust methods used to initially and subsequently assess hedge effectiveness to disregard certain mismatches between the designated hedging instrument and hedged item. • Use a qualitative method to assess hedge effectiveness, if the entity has already performed an initial hedge effectiveness review for a cashflow hedge. • Disregard the requirement for portfolios of forecasted transactions stating the group of individual transactions must share the same risk exposure for which they are designated as being hedged.
6. Allow a one-time election to sell or transfer, or both sell, and transfer debt securities classified as held to maturity that reference a rate affected by reference rate reform and classified as held to maturity before January 1, 2020.	Change applies to: • Debt securities classified as held to maturity (HTM) before January 1, 2020.

- **Consistently:** For optional expedients applicable to contract modifications, across all eligible transactions (modified because of the reform and meeting certain scope guidance).
- **On an individual basis:** For optional expedients applicable to hedging relationship
- **One-time election:** For optional expedients applicable to sell or transfer of HTM debt securities without requiring a transfer all remaining debt securities that meet the qualifying conditions.

Application and Timeline

Amendments are effective as of **March 12, 2020** and apply only to contracts, hedging relationships, and other transactions referencing LIBOR, or another reference rate expected to be discontinued due to reference rate reform. Expedients and exceptions do not apply to contract modifications made and hedging relationships entered into or evaluated after **December 31, 2022**, except for hedging relationships existing as of **December 31, 2022**, that an entity has elected certain optional expedients for and are retained through the end of the hedging relationship.

FOR MORE INFORMATION CONTACT:

ARTHUR MIDIANGA
SENIOR CONSULTANT
347-377-0255
arthur.midianga@mazarsUSA.com

LAURENCE KARAGULIAN
DIRECTOR
646-315-6186
laurence.karagulian@mazarsusa.com

VISIT US AT www.mazarsusa.com

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