ICAEW KNOW-HOW
FINANCIAL SERVICES FACULTY

10 ACCOUNTING AND DISCLOSURES QUESTIONS FINANCE SHOULD BE ASKING ABOUT LIBOR TRANSITION

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23 November 2020

The London Inter-Bank Offered Rate (LIBOR) has been the most widely used interest rate benchmark in financial markets and the daily published rates are referenced in an estimated total of around US$400 trillion of financial contracts, including loans, mortgages, bonds, securitised products and derivatives. The transition from LIBOR to the alternative reference rates (RFRs) is essential to strengthen the global financial system and with the end-2021 LIBOR cessation date firmly held, a significant effort is required to effect this change. In response to this, the International Accounting Standards Board (IASB) and the Financial Reporting Council (FRC) have and are respectively amending IFRS and UK GAAP with targeted reliefs to current accounting requirements across a number of areas so that the accounting for LIBOR transition better reflects economic substance[1]. ICAEW's Financial Services Faculty highlight 10 questions to inform the critical areas of accounting and financial disclosure that are being impacted by LIBOR transition.

1. Is your firm aware of amendments that are being affected to accounting and financial reporting as a result of LIBOR transition?

The IASB and FRC are applying a two-phase process in terms of amending financial reporting standards so as to facilitate LIBOR transition. LIBOR transition, within the context of the amendments, means the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate such as those resulting from the recommendations set out in the Financial Stability Board's July 2014 report 'Reforming Major Interest Rate Benchmarks'. The first phase of amendments focused on certain pre-replacement issues that amended specific hedge accounting requirements. This was to provide relief from potential adverse effects that may arise as a result of uncertainty in LIBORs.

- ❑ Monitor discussions that are being held on accounting and financial reporting so as to factor these into wider LIBOR transition programmes.
- ❑ Understand and apply the targeted relief that has or is being issued where appropriate.

2. Is your firm aware of which modifications to financial instruments will be able to avail of accounting relief?

The amendments provide a practical expedient to the requirements of IFRS 9 Financial Instruments (IFRS 9) for IFRS preparers and Section 11 of FRS 102, IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and IFRS 9 for UK GAAP preparers for contractual changes or changes to cash flows that are direct consequence of LIBOR transition and where the new basis for determining the contractual cash flows is economically equivalent to the previous basis. Such changes can be accounted as movements in a floating market rate of interest by updating the effective interest rate without adjusting the carrying amount. This applies to activation of clauses in contracts, changes in methods used to calculate benchmark rates and inclusions of

[1] It is expected that the IASB's and FRC's respective amendments to IFRS and FRS 102 that relate to replacement issues will be endorsed by the EU and issued by the FRC later on this year.

fallback provisions amongst other areas. However, other changes to contracts, such as term extensions, are accounted for using extant requirements.

- ❑ Firms should be taking stock of all contractual changes that it is planning to effect to its financial instruments, identifying those that are required by LIBOR transition and those that are not.
- ❑ Accounting relief should be applied first to those changes that are a required by LIBOR transition.

Questions 3 to 6 relate to the various areas of hedge accounting for which amendments are being proposed.

3. Has you firm assessed its cash flow and fair value hedge accounting relationships in light of the proposed amendments?

The modifying of the hedge accounting designation and associated documentation under IFRS 9, IAS 39 and Section 12 of FRS 102 post designation typically gives rise to discontinuance. However, relief is being provided whereby hedge designation and documentation can be updated to reflect changes in the hedging instrument, hedged item and / or hedged risk that are required as a result of LIBOR transition. Accounting requirements are also being amended in respect of reclassification of amounts accumulated in the cash flow hedge reserve, effectiveness testing under IAS 39 and the re-measurement of hedging instruments and hedged items when transitioning from LIBOR to alternative risk free rates.

- ❑ Determine which cash flow and fair value hedge accounting relationships include a hedge of a LIBOR.
- ❑ Plan for the transition in benchmark rates in terms of modifying hedge designation and hedge documentation.
- ❑ Be aware of the areas of hedge accounting for which relief is or will be available so that it can be availed of.

4. Has your firm designated or planning on designating groups of hedged items or the interest rate exposure of a portfolio of financial instruments?

Currently, the benchmark rate that is designated in a hedge accounting relationship would need to be modified for all financial instruments that make up the group of hedged items at the same time. The amendments allow for sub-groups of hedged items to transition at different times from a LIBOR to an alternative risk-free rate as and when the designated hedged risk is updated to refer to the new benchmark rate.

- ❑ Take stock of hedges that include groups of hedged items or the interest rate exposure of a portfolio of financial instruments.
- ❑ Identify and track sub-groups of items that may be transitioning at different times in terms of the risk that is hedged.

5. Has your firm designated or planning on designating non-contractually specified LIBOR-based risk components?

The amendments provide temporary relief to entities applying hedge accounting in terms of IFRS 9's and IAS 39's separately identifiable criteria for non-contractually specified benchmark rate risk components. These amendments allow for an entity to assume that the separately identifiable requirement for such risk components that are impacted by LIBOR transition is met provided it would be separately identifiable in at least 24 months as set out in the amendments, rather than at each reporting date.

- ❑ Identify all hedge accounting relationships for which the hedged risk is a non-contractually specified risk component that is based on a LIBOR.

- ❑ Assess whether the risk component would be separately identifiable within a period of 24 months when using an alternative risk-free rate as the benchmark rate.

6. How is your firm approaching the transitional requirements of these amendments?

Application of these amendments is mandatory and retrospective, which requires reinstating hedge accounting relationships that have been discontinued solely due to changes directly required by LIBOR transition. If an entity cannot do so without using hindsight, then the impact of initial application of the amendments is affected as an adjustment to opening retained earnings.

- ❑ Identify hedge accounting relationships that have been discontinued solely due to changes directly required by LIBOR transition.
- ❑ Assess whether you are able to reinstate these without using hindsight.

7. What are your firm's plans for the disclosures under the reform?

The amendments require an entity to provide disclosures that enable users of financial statements to understand the nature and extent of risks that the entity is facing as a result of LIBOR transition. This is in terms of:

- How the entity is managing those risks,
- The entity's progress in completing the LIBOR transition, and
- How the entity is managing the transition.

These new disclosures also require entities to separately disclose quantitative information about non-derivative financial assets, non-derivative liabilities and derivatives that are linked to LIBOR by LIBOR.

- ❑ Gather the information that is required to adhere to these additional disclosure requirements.

8. Is your firm an insurer that is currently applying the temporary exemption from IFRS 9?

Certain insurers applying IFRS 4 Insurance Contracts may be availing from a temporary exemption from IFRS 9' requirements, under which they continue to apply IAS 39 until IFRS 17 Insurance Contracts (IFRS 17) is effective. This is so as that insurers only go through a big accounting change programme once. By virtue of these amendments, such insurers would also be able to apply the IFRS 9 amendment relating to modifications of financial instruments required by LIBOR transition under IAS 39.

- ❑ Insurers should be taking stock of all contractual changes that it is planning to effect to its financial instruments, identifying those that are required by LIBOR transition and those that are not.
- ❑ Accounting relief should be applied first to those changes that are a required by LIBOR transition.
- ❑ Monitor LIBOR transition given this impacts the asset side of your balance sheet in addition to the liability side.

9. Is your firm a lessee under a lease contract that has cash flows that are linked to LIBOR?

The cash flows arising under a lease contract may be linked to a LIBOR. Currently, under IFRS 16 Leases, lessees would be required to account for a change in the contract to refer to an alternative risk-free rate as a lease modification. The amendments provide relief for lessees in respect of changes required by LIBOR transition whereby they treat the change in rate as a change in a floating rate of interest.

- ❑ Review lease contracts so as to identify those that have cash flows that are linked to a LIBOR.

- ❑ Accounting relief should be applied first to those changes that are a required by LIBOR transition.

10. How is your firm impacted by areas that are not amended by the amendments?

There are areas, such as IFRS 9's contractual cash flow test, discount rates, IFRS 13 Fair Value Measurement and IFRS 17 insurance contract accounting, where no amendments have been proposed. This is because standard setters are of the view that the standards themselves already address the implications of LIBOR transition and amending the standards would result in a loss of useful information. There may be one-off or longer-term impacts on carrying amounts as a result.

- ❑ Ensure your firm is aware of the areas of accounting and financial reporting that are not being amended for LIBOR transition but are either directly or indirectly by this transition.

Also refer to the 10 Questions the ICAEW's Financial Services Faculty highlights on **External Audits** for LIBOR Transition

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