Deloitte.

Heads Up | Volume 27, Issue 25
November 6, 2020

In This Issue

FASB Issues Proposal to Refine the Scope of ASC 848 in Response to Reference Rate Reform

by Jun Ryu, Jon Howard, and Andrew Pidgeon, Deloitte & Touche LLP

On October 29, 2020, the FASB issued a proposed ASU[1] that would refine the scope of ASC 848[2] and clarify some of its guidance as part of the Board's monitoring of global reference rate reform activities. The proposed amendments would permit entities to elect certain optional expedients and exceptions when accounting for derivative contracts and certain hedging relationships affected by changes in the interest rates used for discounting cash flows, for computing variation margin settlements, and for calculating price alignment interest (PAI[3]) in connection with reference rate reform activities underway in global financial markets (the "discounting transition").

Comments on the proposed ASU are due by November 13, 2020. For ease of reference, the proposal's questions for respondents are reproduced in the appendix of this *Heads Up*.

Background

Global market participants are undertaking efforts to transition from using or referencing the London Interbank Offered Rate (LIBOR) and other interbank offered rates to using or referencing alternative reference rates. Such efforts have included changes made by certain central clearing parties (CCPs) to the interest rates used for discounting and for variation margin settlements and PAI. For example, on July 24, 2020, the Chicago Mercantile Exchange

[1] FASB Proposed Accounting Standards Update (ASU), *Reference Rate Reform (Topic 848): Scope Refinement*.
[2] For titles of *FASB Accounting Standards Codification* (ASC or the "Codification") references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."
[3] PAI is also referred to as the price alignment amount (PAA) by the London Clearing House, and price alignment (PA) by the Chicago Mercantile Exchange.

(CME) changed the interest rate used in certain euro contracts for discounting and PAI from the Euro Overnight Index Average (EONIA) to the Euro Short-Term Rate (ESTR). In addition, on October 16, 2020, it changed the interest rate used in U.S. dollar contracts for discounting and PAI from the daily Effective Federal Funds Rate (EFFR) to the Secured Overnight Financing Rate (SOFR).[4] Interest rate transitions such as the CME's changes do not necessarily replace reference rates that are expected to be discontinued (e.g., the daily EFFR is not expected to be discontinued), and they are not limited to contracts that reference a rate that is expected to be discontinued (e.g., the CME's interest rate transition applies to all U.S. dollar interest rate products, not only those that reference LIBOR or another rate that is expected to be discontinued). The CME's interest rate transitions, for example, are intended to increase the trading volume in alternative reference rates (e.g., ESTR and SOFR).

The discounting transition may also affect collateralized bilateral derivative transactions, not all of which are indexed to a rate that will be discontinued as a result of reference rate reform. The proposed ASU is intended to reduce diversity in practice related to accounting for (1) modifications to the terms of affected derivatives and (2) existing hedging relationships in which the affected derivatives are designated as hedging instruments.

This *Heads Up* should be read alongside Deloitte's March 23, 2020, ***Heads Up***.

Main Provisions of the Proposed Amendments

Scope (ASC 848-10)

The FASB acknowledges that not all derivative contracts subject to the discounting transition reference LIBOR or other interbank offered rates that are expected to be discontinued. For example, the discounting transition will affect derivative contracts that currently reference and will continue to reference other interest rates (e.g., EFFR, SOFR, the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate). However, the current scope of ASC 848 does not include such contracts. As stated in paragraph BC9 of the proposed ASU, ASC 848 was intended to provide relief related to "contracts and transactions that reference LIBOR or a reference rate that is expected to be discontinued as a result of reference rate reform." Accordingly, the proposed amendments would expand the scope of ASC 848 to include all affected derivatives and give market participants the ability to apply certain aspects of the contract modification and hedge accounting expedients to derivative contracts affected by the discounting transition.

Contract Modification (ASC 848-20)

ASU 848-20-35-1 currently indicates that an entity that elects to use a contract modification expedient under a particular Codification topic, subtopic, or industry subtopic must apply that expedient to all contract modifications accounted for under that guidance. The proposed ASU would provide an exception to those requirements that permits an entity to also elect to apply the expedient to all other derivative contract modifications related to reference rate reform on a different date (i.e., when other modifications are made).

Connecting the Dots

ASC 848-20-35-4 and ASC 848-20-55-2 can be applied to derivative contracts affected by the discounting transition. That is, an entity can conclude that a contract previously determined to be a derivative in accordance with ASC 815 continues to meet the definition of a derivative and not a hybrid instrument in situations in which the terms of the contract change as a result of the discounting transition. Further, in accordance with ASC 815-10-45-11 through 45-15, an entity does not need to reassess whether the contract includes a financing element.

4 See the CME's "SOFR Discounting Transition Process for Cleared Swaps," August 2020.

Hedging — General (ASC 848-30)

The proposed ASU would permit an entity to elect certain hedging relief if it has designated a derivative as a hedging instrument in a hedging relationship and the terms of the derivative (e.g., discount rate) have changed as a result of the discounting transition.

Connecting the Dots

In situations in which a derivative is designated as a hedging instrument in a hedging relationship and the interest rate used for discounting cash flows to calculate variation margin settlements and PAI has changed as a result of the discounting transition, questions have arisen about whether the change was made to critical terms of the hedging relationship. The proposed ASU clarifies that ASC 848-30-25-7 continues to apply to the affected derivative; that is, a change in the interest rate as a result of the discounting transition would not be considered a change to the critical terms of a hedging relationship. An entity can continue to apply hedge accounting without dedesignating the existing hedging relationship.

A cash settlement (or equivalent) may be exchanged to neutralize the change in the fair value of a derivative affected by the discounting transition. If such a derivative is designated as a hedging instrument in a cash flow hedging relationship, that cash settlement may create a mismatch between the fair value of the hedging instrument and the amount deferred in accumulated other comprehensive income (AOCI).

An entity that assesses hedge effectiveness of a cash flow hedge relationship by using a method that allows an assumption of perfect hedge effectiveness would be permitted under the proposal to elect the relevant optional expedients and subsequently apply the original effectiveness assessment method under which it continues to assume that the hedge is perfectly effective after the discounting transition. Alternatively, the entity can elect to change to any applicable quantitative method of assessing the effectiveness of a cash flow hedge in ASC 815-20 and ASC 815-30 without dedesignating the hedging relationship.

The proposed ASU would require an entity that originally applied a quantitative or qualitative method in accordance with ASC 815-20 and ASC 815-30 to continue to apply the same method when performing its subsequent effectiveness assessment of a cash flow hedge relationship that was affected by the discounting transition. In addition, the entity would be able to use a reasonable approach to adjust the amount recorded in AOCI for the cash settlement (or equivalent) as a result of the discounting transition. Any adjustment to AOCI would be recognized in the income statement in the same manner as other reclassifications out of AOCI related to the hedging relationship.

Connecting the Dots

The proposed ASU and ASC 848 do not specify the method an entity should use to adjust the amount in AOCI for the cash settlement (or equivalent) as a result of the discounting transition, only that such method should be reasonable. However, an entity should apply its elected method consistently to similar hedges. An entity that does not elect to adjust the amount recorded in AOCI as a result of the discounting transition should ensure that all such amounts are reclassified into earnings when the hedged transaction affects earnings or when it is probable that the hedged transaction will no longer occur.

In fair value hedging relationships for which the shortcut method is used, a receipt or payment of a cash settlement (or equivalent) as a result of the discounting transition may also cause a mismatch in the cumulative change in fair value of the hedging instrument (e.g., an interest rate swap) and the cumulative-basis adjustments applied to the hedged item (e.g., fixed-rate debt hedged for changes in fair value because of changes in LIBOR). That is, the cumulative-basis adjustments will not be naturally unwound as settlements occur on the hedging instrument. The proposed ASU addresses this issue by adding an optional expedient that would permit an entity to use a reasonable approach to adjust the cumulative-basis adjustment for the amount equal to the fair value change in the hedging instrument (i.e., a cash settlement or equivalent) as a result of the discounting transition. An entity could also elect, as an optional expedient, to continue to apply the shortcut method when assessing the effectiveness of the hedging relationship affected by the discounting transition.

In connection with the discounting transition, an entity may receive a series of basis swaps (e.g., EFFR for SOFR) simultaneously with a payment or receipt of a cash settlement (or equivalent). The proposed ASU would allow the entity to add one or more, or proportions of, basis swaps to a derivative designed as a hedging instrument in a hedging relationship without having to dedesignate the hedging relationship if the hedging instrument is affected by, and those basis swaps are received as a result of, the discounting transition. Subsequent removal of one or more, or proportions of, basis swaps that were added to the designated hedging instrument would also not result in dedesignation of the hedging relationship.

Connecting the Dots

The proposed ASU does not otherwise specifically address the subsequent accounting for basis swaps, which are separate freestanding derivatives subject to ASC 815.

Fair Value Hedges (ASC 848-40)

The proposed ASU would allow an entity to change the designated benchmark interest rate in a fair value hedge relationship if a designated derivative is affected by the discounting transition.

As discussed above, the proposed amendment to ASC 848-30-25-10 allows an entity to continue to apply the shortcut method when subsequently assessing effectiveness of a fair value hedging relationship affected by the discounting transition. This optional expedient will be available until the remainder of the original hedging relationship that includes periods after December 31, 2022. However, if an entity also elects the expedient that permits it to add one or more, or proportions of, basis swaps received as a result of the discounting transition to an existing hedging relationship for which the shortcut method is applied, the proposed ASU would not permit the entity to continue to apply the shortcut method after December 31, 2022. In other words, the entity must cease the application of the shortcut method after December 31, 2022, and change to another effectiveness assessment method in ASC 815-20 and ASC 815-25.

Connecting the Dots

The election to apply any of the expedients discussed would not result in dedesignation of the existing fair value hedge relationship, but the entity would be required to update the hedge documentation to identify the elections.

Cash Flow Hedges (ASC 848-50)

If a derivative that is affected by the discounting transition is already designated in a cash flow hedging relationship using a hedge effectiveness assessment method under which perfect effectiveness was assumed, the proposal would allow an entity to continue to do either of the following:

- Apply the corresponding optional expedient to assume perfect effectiveness in accordance with the expedients previously provided by ASU 2020-04.[5]
- Change its effectiveness approach to a quantitative method in accordance with ASC 815-20 and ASC 815-30.

[5] FASB Accounting Standards Update No. 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*.

Regardless of which alternative it selects, an entity can make its election without dedesignating the hedging relationship.

Provisions That Were Not Directly Amended but Can Be Applied to the Affected Derivatives

The proposed ASU would not amend certain optional expedients and exceptions in ASC 848. However, the FASB clarifies in the proposed ASU that an entity would apply the optional expedients and exceptions described in the table below (reproduced from the proposed ASU) to derivative contracts that are affected by the discounting transition.

Codification Subtopic	Provisions That Apply to Derivatives Affected by the Discounting Transition That Were Not Directly Amended
Reference Rate Reform — Contract Modifications (848-20)	• Option to not reassess a previous accounting determination (paragraph 848-20-35-4). • Flowchart that summarizes how to navigate Topic 848 (paragraph 848-20-55-1). • Implementation guidance that illustrates relief in paragraph 848-20-35-4, including relief from reassessing whether a modified derivative is a hybrid instrument and includes a financing element (paragraph 848-20-55-2).
Hedging — General (848-30)	• Option to apply the hedging relief on an individual hedge basis (paragraph 848-30-25-2). • Option to not dedesignate a hedging relationship due to a change in a critical term (paragraph 848-30-25-3). • Requirement to update hedge documentation for a change in a critical term (paragraph 848-30-25-4). • Option to change the contractual term of a hedging instrument, hedged item, or forecasted transaction and to not dedesignate a hedging relationship (paragraph 848-30-25-5). • Guidance that a change in the interest rate used for margining, discounting, or contract price alignment of a derivative hedging instrument should not be considered a change to the critical terms of the hedging relationship (paragraph 848-30-25-7). • Option to change the systematic and rational amortization method for excluded components (paragraphs 848-30-25-12 through 25-13).
Fair Value Hedges (848-40)	• Requirement for an entity that elects to apply the optional expedients in this Subtopic to continue to apply all other requirements applicable to fair value hedges in Subtopics 815-20 and 815-25 (paragraph 848-40-15-1). • Option to apply the fair value hedging relief on an individual hedge basis (paragraph 848-40-25-1). • Requirement to update hedge documentation upon a change in the designated benchmark rate (paragraph 848-40-25-3). • Requirements and expedients related to continuing fair value hedge accounting without dedesignation if an entity elects to change the designated benchmark interest rate (paragraphs 848-40-25-4 through 25-7 and 848-40-25-9).

(Table continued)

Codification Subtopic	Provisions That Apply to Derivatives Affected by the Discounting Transition That Were Not Directly Amended
Cash Flow Hedges (848-50)	• Requirement for an entity that elects to apply the optional expedients in this Subtopic to continue to apply all other requirements applicable to cash value hedges in Subtopics 815-20 and 815-30 (paragraph 848-50-15-1). • Option to apply the cash flow hedging relief on an individual hedge basis (paragraph 848-50-25-1). • Option to apply the optional expedients in this Subtopic prospectively and the requirement to update hedge documentation if electing an optional expedient in this Subtopic (paragraphs 848-50-35-2 through 35-3). • Option to apply a subsequent effectiveness assessment method that assumes perfect effectiveness if an entity was applying the corresponding perfectly effective method under Subtopics 815-20 and 815-30 before the discounting transition (paragraphs 848-50-35-4 through 35-9). • Guidance on assessing hedge effectiveness when optional expedient methods are discontinued (paragraphs 848-50-35-21 and 848-50-35-23).

Effective Date and Transition

The amendments in the proposed ASU would be effective, once finalized, for all entities as follows:

Type	Effective Date and Expiration Date
Contract modifications	Entities would use either of the following approaches to apply the amendments to modifications to the terms of the derivatives affected by the discounting transition: • Retrospective as of any date from the beginning of an interim period that includes March 12, 2020. • Prospective from a date within an interim period that includes or is after the issuance date of the final ASU, up to the date that the financial statements are available to be issued.
Hedging relationships[6]	Entities would apply the amendments to either of the following types of eligible hedging relationships affected by the discounting transition: • Those existing as of the beginning of the interim period that includes March 12, 2020. • Those entered into after the beginning of the interim period that includes March 12, 2020.

[6] Once finalized, the guidance in the proposed ASU would require any private company that is not a financial institution as described in ASC 942-320-50-1 and any not-for-profit entity (except for a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market) and that adopts any of the proposed amendments related to a hedging relationship to update its hedge documentation before the next interim (if applicable) or annual financial statements are available to be issued. All other entities would be required to update their hedge documentation no later than when those entities perform the first quarterly hedge effectiveness assessment after making any elections in the proposed ASU for that hedging relationship.

The amendments do not apply to (1) contract modifications made or new hedging relationships entered into after December 31, 2022, or (2) existing hedging relationships evaluated for periods after December 31, 2022, unless an entity elects to apply certain optional expedients that permit the accounting effects to be retained through the end of the hedging relationships that extend beyond December 31, 2022. Under those optional expedients, an entity would:

- Use a reasonable approach to modify the fair value hedge basis adjustment in a fair value hedge accounted for under the shortcut method.
- No longer periodically evaluate the conditions in ASC 815-20-25-104(d) and (g) when using the shortcut method for a fair value hedge. However, the entity's application of the shortcut method would cease after December 31, 2022, if the entity elects the optional expedient to add one or more, or a proportion of, basis swaps to a fair value hedging relationship as a result of the discounting transition.
- Use a reasonable approach to adjust the amount recorded in AOCI for a cash flow hedge affected by a receipt or payment of a cash settlement (or equivalent) as a result of the discounting transition.
- Continue to use a subsequent assessment method under which perfect effectiveness is assumed in accordance with ASC 848-50-35-4 through 35-9 for a cash flow hedge if the entity elected the practical expedient that permits it to use a reasonable approach to adjust the amount recorded in AOCI as a result of the discounting transition.

Connecting the Dots

Under the proposed ASU, any private company that has not yet adopted ASU 2017-12[7] is only allowed to elect the expedient permitting it to change the method designated for use in assessing the effectiveness of a hedging relationship if it elects the optional expedient under which it may apply "the simplified hedge accounting approach for eligible private companies or for subsequent hedge effectiveness in paragraph 848-50-35-7" after the discounting transition.

[7] FASB Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*.

Appendix — Questions for Respondents

The proposed ASU's questions for respondents are reproduced below for reference.

Question 1 — Scope Refinement: Do you agree that the scope of Topic 848 should be refined to include contracts that do not reference a rate expected to be discontinued as a result of reference rate reform but that are affected by the discounting transition? Why or why not?

Question 2 — Operability: The Board is proposing amendments in this Update to the expedients and exceptions in Topic 848 to capture the incremental consequences of the proposed scope refinement and tailor the existing guidance to derivative instruments affected by the discounting transition. Are those proposed amendments complete and operable? If not, what suggestions do you have and why?

Question 3 — Effective Date and Transition: Do you agree with the proposed effective date and transition guidance? Why or why not?

Question 4 — Ongoing Monitoring: Are there other accounting consequences related to reference rate reform that the Board should consider?

Dbriefs for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts in the "Financial Executives" series on the following topics:

- Business strategy and tax.
- Controllership perspectives.
- Driving enterprise value.
- Financial reporting.
- Governance, risk, and compliance.
- Innovation in risk and controls.
- Tax accounting and provisions.
- Transactions and business events.

Dbriefs also provides a convenient and flexible way to earn CPE credit — right at your desk.

Subscriptions

To subscribe to *Dbriefs*, or to receive accounting publications issued by Deloitte's Accounting and Reporting Services Department, please register at My.Deloitte.com.

The Deloitte Accounting Research Tool

Put a wealth of information at your fingertips. The Deloitte Accounting Research Tool (DART) is a comprehensive online library of accounting and financial disclosure literature. It contains material from the FASB, EITF, AICPA, PCAOB, and SEC, in addition to Deloitte's own accounting manuals and other interpretive guidance and publications.

Updated every business day, DART has an intuitive design and navigation system that, together with its powerful search and personalization features, enable users to quickly locate information anytime, from any device and any browser. While much of the content on DART is available at no cost, subscribers have access to premium content, such as Deloitte's *FASB Accounting Standards Codification Manual*. DART subscribers and others can also subscribe to *Weekly Accounting Roundup*, which provides links to recent news articles, publications, and other additions to DART. For more information, or to sign up for a free 30-day trial of premium DART content, visit dart.deloitte.com.