IBOR reform phase 1 amendments

Reporting Update

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Highlights

- What's the issue?
- Actions for management to take now
- What else should entities consider?
- More detail…

What's the issue?

Entities should early adopt the IBOR phase 1 amendments

From 2022, there will be a transition from the use of the Interbank Offered Rates (IBOR), including the London Interbank Offered Rate (LIBOR), as the predominant benchmark interest rate to other alternative rates for five currencies. The LIBOR for US Dollar, Pound Sterling, Euro, Japanese Yen and Swiss Franc will be replaced by risk free rates (RFRs). As a result of this global IBOR reform, an entity's ability to continue hedge accounting may be impacted. If an entity has:

- **Borrowings** that references an IBOR benchmark, and/or
- **Derivatives** referencing IBOR benchmarks, and
- **Applies hedge accounting** in accordance with AASB 9 *Financial Instruments* (AASB 9) and AASB 139 *Financial Instruments: Recognition and Measurement* (AASB 139),

it should early adopt the AASB 2019-3 *Amendments to Australian Accounting Standards – Interest Rate Benchmark Reform* ("IBOR Phase 1 amendments"), to ensure that hedge accounting can continue to be applied.

For example…

- Company A borrows funds offshore at floating rates of interest that references USD LIBOR. This floating rate debt is swapped back into a fixed or floating AUD interest rate. The debt and the swap are designated in a hedge accounting relationship.
  - Company A can no longer conclude that the hedged IBOR-based cash flows are "highly probable" as USD LIBOR will no longer be supported after 2021.
- Company B has fixed rate borrowings in the UK. Its risk management strategy involves swapping the fixed rate debt back to a floating AUD rate and designating the debt and the swap into a fair value hedge accounting relationship.
  - Whilst in this case the "highly probable" test does not apply, the entity may have identified an IBOR benchmark as the hedged risk – i.e. the GBP LIBOR component of the fixed interest rate on the debt instrument. The move away from IBOR raises questions as to whether that IBOR risk component can continue to be considered "separately identifiable".

In both these examples, if the entities do not early adopt the IBOR phase 1 amendments, this may result in the discontinuation of these hedging relationships.

Actions for management to take now

Minimal financial impact

Management are encouraged to early adopt the amendments to ensure the continuation of hedge accounting.

Minimal impact on adoption

As the amendments provide relief for financial instruments directly affected by uncertainties related to IBOR reform to qualify for hedge accounting, adoption of the IBOR phase 1 amendments is not expected to result in a quantitative impact to the financial statements. However, there will be additional disclosures to be included in the financial statements.

Additional disclosures

Entities who early adopt the amendments should disclose this fact in their financial statements.

Entities should also disclose the following in their annual financial statements:

- the significant interest rate benchmarks to which the hedging relationships are exposed;
- the extent of risk exposure that is affected by IBOR reform;
- how the transition to alternative benchmark interest rates is being managed;
- a description of significant assumptions or judgements made in applying the amendments; and
- the nominal amount of the hedging instruments in those hedging relationships.

What else should entities consider?

Consider what happens when uncertainty is no longer present

An entity must cease to apply the amendments prospectively when the uncertainty regarding the timing and the amount of interest rate benchmark based cash flows is no longer present.

The uncertainty may no longer be present, for example, when contracts are modified to effect a replacement of the reference benchmark or the instruments revert to a contractually specified fall back interest rate.

The International Accounting Standards Board (IASB) is considering further amendments to permit these entities to reset their retrospective assessment test to zero at the time when the amendments no longer apply.

"Entities with hedge accounting relationships impacted by IBOR reform need to take action to ensure hedge accounting can continue."

Patricia Stebbens
Partner, Department of Professional Practice

IBORs are moving to a new benchmark by the end of 2021

Phase 1 amendments finalised

Phase 2 amendments - exposure draft underway

More detail...

Background

IBOR benchmarks are estimated to underpin approximately $420 trillion dollars of contracts globally. IBORs are typically used in treasury, funding and leasing arrangements and are embedded in a range of risk and finance processes.

For further details about IBOR reform including the expected replacement benchmarks and potential operational impacts for entities to consider, refer to 19RU-010 Are you ready for a world beyond LIBOR.

IASB response to IBOR reform

In response to IBOR reform, the IASB is engaged in a two-phase process of amending accounting standard requirements to assist in a smoother transition away from IBOR.

- Phase one
  - Focuses on hedge accounting issues related to uncertainties arising in the period leading up to the replacement of IBOR.
  - Provides relief from potential effects of the uncertainty caused by IBOR reform.
  - The amendments are mandatory for all hedge relationships directly affected by interest rate benchmark reform.
  - Amendments are effective for annual reporting periods beginning 1 January 2020 but early application is permitted.
- Phase two
  - IASB started work on Phase 2 commencing October 2019, and has issued an exposure draft (ED) on the Phase 2 amendments.
  - The second phase of its project focuses on broader financial reporting issues that may arise when IBOR are either reformed or replaced.
  - The IBOR phase 2 ED attracted 80 comment letters, and the IASB is expected to finalise its discussions on this feedback at the July Board meeting.