In the Spotlight

A Corporate Treasury Focus on Phase 2 Amendments for Interest Rate Benchmark (IBOR) Reform

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IBOR Phase 2: Top Accounting Issues for Corporate Treasurers

At a glance

The IASB has issued further amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 that address issues arising during the reform of benchmark interest rates, including the replacement of one benchmark rate with an alternative one. The amendments are effective from 1 January 2021. In this Spotlight we focus on the implications for corporate entities (that is, non-financial institutions) and, in particular, their treasury function. This Spotlight will focus on:

- changes in the basis for determining contractual cash flows of financial assets and financial liabilities measured at amortised cost;
- hedge accounting; and
- IFRS 16, 'Leases'.

While this Spotlight focuses on the areas listed above, there might be other related accounting issues. Entities are reminded to consider all potential accounting issues and to refer to In depth: Practical guide to Phase 2 amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 for interest rate benchmark (IBOR) reform.

1. Introduction

This publication focuses on the impact on corporate entities' accounting when applying the IASB's Phase 2 amendments on benchmark reform. For a more in-depth look at the Phase 1 reliefs and the linkage between the Phase 1 and Phase 2 implications, please refer to the following publications:
In depth 2019-04: Practical guide to Phase 1 amendments IFRS 9, IAS 39 and IFRS 7 for IBOR reform
In depth 2020-06: Practical guide to Phase 2 amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 for interest rate benchmark (IBOR) reform

2. Changes in the basis for determining contractual cash flows of financial assets and financial liabilities measured at amortised cost or FVOCI

Benchmark rate reform means that many contracts that currently have cash flows based on an IBOR benchmark rate will need to be amended and, in the future, the financial instruments (including lease contracts for a lessee) will be measured based on the new benchmark rate. Without the exemptions in IFRS 9 and IFRS 16, this change in measurement basis might have resulted in a gain/loss, because it would have led to either a modification or derecognition of the instruments. With the practical expedient, the carrying amount remains unchanged, as discussed in more detail below.

Examples of affected instruments that should be considered in a corporate treasury environment include:

- cash equivalents;
- loans and other receivables (including long-term trade receivables);
- borrowings, lease liabilities (for lessees – see Section 4 below) and certain other payables; and
- inter-company loan arrangements (receivables and payables).

The reliefs from considering changes in the basis for determining contractual cash flows are not relevant to the measurement of derivative instruments, since they are already carried at fair value through profit or loss. However, the manner in which those instruments are amended for IBOR reform could affect the ability to use the hedge accounting reliefs (see Section 3 below).

PwC observation

Long-term payables and receivables will, by their nature, be more affected by IBOR reform and, although the interest rate receivable or payable on cash equivalents such as deposits or money market funds will change, this is unlikely to have a material accounting impact due to their short-term nature.

Inter-company arrangements are also unlikely to be the focus of attention for some groups. However, where external variable-rate debt has been passed to another group company on a back-to-back basis, both companies will need to ensure that the intra-group loan is also updated and/or that the external finance costs are still covered.

Many groups have complex debt arrangements. This publication is not focused on the tax implications but, for example, entities might need to meet certain tax transfer pricing or corporate interest restriction rules. Any changes made for IBOR reform need to consider whether the new rate will still be seen as arm's length (especially if any amendments are not solely required as a direct consequence of the reforms but made for other commercial reasons). If not, there could be implications for current or deferred tax balances.

The changes above all need to be factored into the overall strategy and project management process. Corporate treasurers should liaise with their tax specialists and other relevant counterparties.

2.1 Current accounting treatment

A change in the market rate of a floating-rate instrument is treated in line with IFRS 9 para B5.4.5 for which the cash flows are periodically updated, together with the effective interest rate curve used for discounting, which normally has no significant effect on the carrying amount of the asset or the liability.

However, for changes not arising under the original contractual terms, management needs to assess whether this leads to a modification gain or loss (IFRS 9 para 5.4.3 for financial assets and B5.4.6 for financial liabilities) or derecognition, where the change is substantial in line with IFRS 9 paragraph 3.2.3a for financial assets and IFRS 9 para 3.3.2 for financial liabilities. This assessment and calculation of relevant gain or loss can be complex, and it might not be intuitive to the readers of the accounts, and so the practical expedient (explained in 2.2 below) is very welcome.

2.2 IASB Phase 2 practical expedient

Following IBOR reform, contracts that have a rate based on an IBOR (for example, GBP LIBOR) will be directly impacted when the rate changes to the alternative reference rate (for example, SONIA). Such changes can be due to:

- an amendment to the contractual terms specified at initial recognition (for example, if the contract is amended to replace the benchmark rate with an alternative one);
- a change that was not considered or contemplated in the contractual terms at initial recognition (for example, if the method of calculating the benchmark rate is changed, even though the contractual terms are not); or
- as a result of the activation of an existing contractual term (for example, triggering of an existing fallback clause in a contract).
  [IFRS 9 paras 5.4.5, 5.4.6].

The practical expedient applies to qualifying changes to the basis for determining contractual cash flows for financial

assets and liabilities (including lease liabilities) that are required by interest rate benchmark reform – that is, they are necessary as a **direct consequence of IBOR reform** and are **economically equivalent**.

Changes that will qualify for the practical expedient will be treated in line with IFRS 9 para B5.4.5. The effect is that the carrying amount remains unchanged by the process of re-estimating future cash flows and updating the effective interest rate. Any other changes to the terms that do not qualify for the expedient above will need to be assessed separately, and they could result in modification or derecognition of the original asset or liability. Under modification accounting, a gain or loss is recognised under IFRS 9 para 5.4.3 or IFRS 9 para B5.4.6. Similarly, if derecognition applies, the original asset and liability will be removed from the balance sheet and replaced with a new asset or liability measured at fair value. This is known as the two-step approach, and it is explained in more detail in the In depth on Phase 2 referred to in Section 1 above. The two-step approach is not applicable to lessees (see Section 4 below).

Example 1 – Benchmark interest rate change

Entity A funded itself by entering into a 20-year IBOR borrowing of GBP 10 million in 2015. Every month, it pays interest based on the 1-month IBOR rate with a fixed spread of 10bps. As a consequence of IBOR reform, the bank has amended the contract, with the change commencing on 1 August 2021, whereby the 1-month IBOR rate will be replaced by an alternative risk-free rate (RFR) with a fixed spread of 100bps.

Management evaluated the changes and concluded that both the change in the reference rate and the change in the fixed spread are a **direct consequence** of the IBOR reform.

Furthermore, management concluded that the change in the fixed spread (from 10bps to 100bps) is equal to the market-observed forward spread between the IBOR and the RFR at 1 August 2021, over the expected remaining life of the instrument, and so the new basis for determining cash flows is **economically equivalent** to the previous basis. The approach being applied here is the forward spread approach[1].

At the date of the change, the practical expedient is applied and the effective interest rate is updated based on the new RFR, by applying IFRS para B5.4.5. Therefore, the changes will not result in an immediate gain or loss in the income statement.

[1] There are various accepted methods for assessing the economically equivalent criterion. For further detail, see FAQ 2.2 – What does 'economically equivalent' mean?.

Further guidance is given in:

- FAQ 2.1 – What does 'required as a direct consequence of interest rate benchmark reform' mean?

PwC observation

Corporate treasurers are likely to be responsible for agreeing the changes to the relevant financial instruments. To simplify an entity's or group's banking arrangements, the corporate entity or bank might suggest aligning the terms of loan arrangements as part of the IBOR reform process.

Treasurers should be aware of the accounting implications of agreeing other commercially appropriate changes to the rate or to the instrument's terms, such as a term extension or inclusion of a floor. These are unlikely to be 'required as a direct consequence', and so they could restrict the benefit obtained from the practical relief. Any other changes would still need to be assessed under IFRS 9 for derecognition or modification, and they could result in recognition of a gain or loss.

PwC observation

As noted above, there are various accepted methods for assessing the economically equivalent criterion. The markets will continue to develop for the new rates, and views of what is appropriate and what is a direct consequence might also evolve. We therefore recommend continuing to consult with advisers, especially on more complex arrangements.

For example, the replacement benchmark rate could be any reasonable alternative to the original IBOR rate for that change to be considered a 'direct consequence' of IBOR reform (for example, a move from GBP LIBOR to the Bank of England base rate would be considered a 'direct consequence' of IBOR reform, as would a move from GBP LIBOR to SONIA). Furthermore, the replacement benchmark rate does not need to have the same term as the original IBOR rate if there is insufficient liquidity in that term in the replacement benchmark rate. For example, for a 3-month IBOR contract, the replacement would not need to be a 3-month alternative benchmark rate to be a 'direct consequence' if that term is not available or not sufficiently liquid at the point of changing the contract. Conversely, moving to a 5-year alternative benchmark rate from a 3-month IBOR rate would not be expected to be a reasonable alternative if a liquid overnight alternative benchmark rate were also available (that is, it would not be viewed as a direct consequence of benchmark reform).

3. Hedge accounting

The change in benchmark interest rate will mean that hedge accounting relationships are affected where the hedged item, hedging instrument or designated hedged risk has a reference to an affected benchmark rate. When such changes take place, the Phase 2 amendments require entities to update their hedge designation, the implications of which are discussed in more detail below.

3.1 Temporary exception for changes made to the hedge designation and hedge documentation

When an entity ceases to apply the Phase 1 reliefs explained in In depth 2019-04, the Phase 2 amendments require an entity to make changes to the formal designation and documentation of the hedge relationship, to reflect the changes that are required by IBOR reform. Similar to the practical expedient for changes in the basis of contractual cash flows of financial assets and financial liabilities, the change must be necessary as a **direct consequence** of interest rate benchmark reform, and the new basis should be **economically equivalent** to the previous basis.

The hedge designation and documentation will, in this context, be amended only to make one or more of the following changes:

- designating an alternative benchmark rate as a hedged risk;
- amending the description of the hedged item (including the description of the designated portion of the cash flows or fair value being hedged); or
- amending the description of the hedging instrument.

[IFRS 9 para 6.9.1]. [IAS 39 para 102P].

The amendments state that the hedge designation relating to the hedging instrument (see third bullet above) must also be updated if the following three conditions are met:

- the entity makes a change required by IBOR reform using an approach other than changing the basis for determining the contractual cash flows of the hedging instrument;
- the original hedging instrument (for example, the derivative) is not derecognised; and
- the approach is economically equivalent to changing the basis for determining the contractual cash flows of the original hedging instrument.

[IFRS 9 para 6.9.2]. [IAS 39 para 102Q].

An example amendment would be to change the designated hedged risk from GBP LIBOR to SONIA. Previously, the entity could have used the Phase 1 'highly probable' relief to assume that the interest rate on which the hedged risk was based did not change as a result of the reform. [IFRS 9 para 6.8.4]. [IAS 39 para 102D]. That relief ends once the uncertainty arising from IBOR reform is no longer present, with respect to the timing or amount of benchmark-based interest cash flows, and therefore the hedge designation and documentation will need to be updated.

The formal hedge documentation must be amended by the end of the reporting period during which a change required by IBOR reform is made to the hedged risk, hedged item or hedging instrument. Amending the formal

designation and documentation of a hedging relationship, as required by this temporary exception, is not the discontinuation of the hedge relationship nor the designation of a new hedging relationship. [IFRS 9 para 6.9.4]. [IAS 39 para 102S].

PwC observation

Treasurers should welcome the practical relief from updating the formal hedge designation as soon as the Phase 1 reliefs cease to apply.

However, the Phase 2 reliefs are only available once a change has been made to the hedge designation. Although entities have relief from updating their hedge documentation until the end of a reporting period, there is nothing to preclude earlier re-documentation and, in fact, this would help to evidence the changes that are made to hedge accounting for the relationship.

3.2 Temporary exception for amounts accumulated in the cash flow hedge reserve

The Phase 1 relief from reclassifying the amount in the cash flow hedge reserve will cease when there is no longer uncertainty arising from IBOR reform in respect of the timing or amount of interest-based cash flows of the hedged item. When the entity amends the description of a hedged item under the temporary exception to amend the hedge designation and documentation (see 'Section 5.3 Amendments to the formal designation of hedge relationships' of In depth 2020-06), the amounts accumulated in the cash flow hedge reserve are deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined. [IFRS 9 para 6.9.7]. [IAS 39 para 102W]. It follows that the original hedge relationship is not treated as discontinued, and IBOR-related fair value movements held in the cash flow hedge reserve do not need to be recycled immediately.

The Phase 2 amendments also provide for a similar temporary exception for previously discontinued cash flow hedges, where the benchmark interest rate on which the hedged future cash flows were based has changed as required by IBOR reform. [IFRS 9 para 6.9.8]. [IAS 39 para 102X]. An example of such a discontinued hedge might be where the hedge objective had changed (the entity no longer wanted to fix the interest rate on a particular debt instrument). The interest cash flows were still expected to occur, and so the accumulated cash flow hedge reserve was being released to profit or loss over the remaining period of the original hedge relationship, and will continue to be, as permitted by the IBOR reform relief.

3.3 Temporary exception for the retrospective effectiveness test (IAS 39 only)

For the purpose of assessing retrospective effectiveness of a hedge relationship on a cumulative basis, an entity could elect, on an individual hedging relationship basis, to reset to zero the cumulative fair value changes of the hedged item and hedging instrument when ceasing to apply the retrospective effectiveness assessment relief provided by the Phase 1 amendments. [IAS 39 para 102V].

For a more detailed discussion on the choice to reset the retrospective effectiveness test on a cumulative basis to zero, see In depth: Practical guide to Phase 2 amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 for interest rate benchmark (IBOR) reform.

PwC observation

The decision whether or not to reset to zero might be driven by how an entity's effectiveness testing is currently set up. However, we recommend that this relief is considered for all material hedge relationships.

If the cumulative testing result is close to the effectiveness threshold of 80–125% due to basis or timing differences, an entity might prefer to reset the relationship. However, if there is likely to be significant market volatility in the first period after transition to the new benchmark rate, the impact might be mitigated by a cumulative effectiveness calculation.

Treasurers should note that there is no exception from the recognition and measurement of hedge ineffectiveness, or the measurement of hedged items and hedging instruments. Therefore, previous sources of ineffectiveness could still create profit or loss volatility.

3.4 Designation of risk components and portions

IFRS 9 paragraph 6.3.7 describes that an entity can designate a component of an item, provided that the risk component is separately identifiable and reliably measurable.

IBOR Phase 2 allows for an alternative benchmark rate designated as a non-contractually specified risk component that is not separately identifiable, at the date when it is designated, to be deemed to have met the requirements at that date if the entity reasonably expects that it will meet the requirements within a period of 24 months.

The 24-month period will:

- apply to each alternative benchmark rate separately (on a rate-by-rate basis); and
- begin from the date when the entity designates the alternative benchmark rate as a non-contractually specified risk component for the first time.

[IFRS 9 para 6.9.11]. [IAS 39 para 102Z1].

The non-contractually specified risk component will, however, be required to be reliably measurable at all times.

If, at a later date, the entity reasonably expects that the alternative benchmark rate will not be separately identifiable within the 24-month period, it will cease to apply the temporary exception and prospectively discontinue hedge accounting from the date of that reassessment. [IFRS 9 para 6.9.12]. [IAS 39 para 102Z2].

This relief will similarly apply to new hedging relationships where the alternative benchmark rate is not separately identifiable at the date when the non-contractually specified risk component is designated. [IFRS 9 para 6.9.13]. [IAS 39 para 102Z3].

For entities reporting under IFRS 9 applying the Phase 2 amendments, further guidance is given in:
FAQ 46.67.3 – When can a new benchmark rate (such as SONIA) be designated as a non-contractually specified risk component of a debt instrument?

PwC observation

This exemption is helpful because corporate treasurers might want to hedge the benchmark rate component of existing and new debt instruments, but the new rates might not yet be separately identifiable.

However, many of the benchmark rates are expected to be separately identifiable in the next 24 months, and so fair value hedges of the benchmark component of fixed-rate debt, for example, should be possible if the entity adopts the Phase 2 IFRS 9 or IAS 39 amendments.

The amendments are applicable for periods beginning after 1 January 2021. Therefore, if an entity wants to designate a new benchmark rate as the hedged risk component in an earlier period, it will need to early adopt the Phase 2 amendments and disclose that fact in the financial statements.

3.5 When might the hedge accounting reliefs not apply?

If additional changes other than those required by IBOR reform are made, an entity will first apply the applicable IAS 39 or IFRS 9 hedge accounting requirements to determine if the changes result in the derecognition of the derivative and/or discontinuance of hedge accounting. If the changes do not result in the derecognition of the derivative and/or discontinuance of hedge accounting, the reliefs will be available, but the designation of the hedge relationship will need to be updated as explained above.

PwC observation

The Basis of Conclusions on both IFRS 9 and IAS 39 describe various methods of ‘transitioning’ derivatives that fall into the reliefs, all of which retain the original hedging instrument in some form or other.

Many corporate entities might just use the ISDA fallback protocols, but others might plan to replace the original hedging instrument with a new instrument. This can be quicker and easier than negotiating changes to old terms, particularly if other changes to notional or terms are needed. However, even if no other changes are made, treasurers should be aware that, in some cases, this might mean that the original hedging arrangement is derecognised and the Phase 2 reliefs are not available.

4. IFRS 16, 'Leases'

The change in rates will mean that many lease contracts with variable lease payments will need to be amended, affecting both lessees and lessors. Without the exemption added to IFRS 16, lessees would need to remeasure the lease liability, with a corresponding adjustment to the right-of-use asset. With the practical expedient, the carrying amount of the lease liability remains unchanged, as discussed in more detail below.

PwC observation

The decision to enter into leases, and accounting for such leases, was not historically a key feature of a corporate treasurer's role, but the decision to lease or borrow and buy has received more focus since the implementation of IFRS 16 led to many more on-balance sheet lease liabilities. Therefore, treasury departments are often part of the decision-making process, and they also help to compute the incremental borrowing rate using their understanding of the appropriate credit spread for secured and unsecured borrowings.

As noted above, many leases will need to be amended, and treasurers might be asked to support the negotiations to ensure that any rate change made by lessors or lessees is a direct consequence of the reform and that the revised payment is economically equivalent.

4.1 Accounting by lessees

IFRS 16 has been amended to include a practical expedient for all leases that are modified to change the basis for determining future lease payments as a result of IBOR reform. As a practical expedient, a lessee will remeasure the lease liability by discounting the revised lease payments using a discount rate that reflects the change in the interest rate. This practical expedient applies only if the lease modification is necessary as a **direct consequence** of IBOR reform, and the new basis for determining the lease payments is **economically equivalent** to the previous basis. [IFRS 16 para 105].

If lease modifications are made in addition to those required by IBOR reform, an entity will be required to apply IFRS 16 requirements to account for all lease modifications made at the same time, including those required by IBOR reform. [IFRS 16 para 106].

4.2 Accounting by lessors

The IASB decided not to amend requirements for lease modifications from a lessor's perspective. For finance lease modifications, the Board noted that a lessor would be required to apply IFRS 9 to those modifications. As a result, a finance lessor would be required to apply the practical expedient relief for modifications required by the reform. This follows the same treatment as for affected financial assets described above, which means that a variable-rate lease asset recognised by the lessor for which there is a qualifying change will be treated in line with IFRS 9 para B5.4.5. The effect is that the carrying amount remains unchanged by the process of re-estimating future cash flows and the effective interest rate.

In addition, the Board noted that, for operating leases, lessors should follow the modification guidance in IFRS 16. [IFRS 16 para BC 267J].

Example 2 – Rate change

On 1 January 2018, entity B entered into a 10-year lease contract for a building with quarterly variable lease payments (entity B is the lessee). The quarterly variable lease payments are based on the 3-month IBOR plus a spread of 50bps.

At the point of initial measurement, the lease liability is measured by assuming unadjusted lease payments over the life of the lease. At the beginning of the next quarter when the rate changes, management remeasures the lease liability to the present value of the revised payments based on 3-month IBOR at the date when the cash flows change for the remainder of the lease term. Because the change in cash flows is caused by a change in floating interest rates, the lease liability is calculated using a revised discount rate. [IFRS 16 para 43].

On 1 January 2022, the lessor and lessee agreed to change the rate from 3-month IBOR plus a spread of 50bps to an alternative risk-free rate (RFR) plus a spread of 150bps. No other changes are made to the contract. Management of entity B assessed (based on the criteria as set out in Example 1) whether this change is a **direct consequence** of the IBOR reform and **economically equivalent** to the previous basis.

Since the change is a direct consequence of the interest rate benchmark reform and economically equivalent, entity B applies the practical expedient to the revised discount rate, meaning that the carrying amount would not typically be adjusted.

5. Disclosures and illustrative examples

We note that the Phase 2 amendments introduce new disclosure requirements, including information about how an entity is managing its benchmark rate transition and financial instruments which have not yet transitioned to the replacement benchmark rate. Illustrative disclosures will be available shortly after the publication of this Spotlight and can be accessed on Viewpoint. A link will be added as soon as it is available.

In addition, for hedge accounting, the interaction between the Phase 1 and Phase 2 reliefs can be complex. Illustrative examples will be published that should help treasurers and financial reporting teams to understand the timelines and the accounting and reporting implications of changes made to the hedged item and hedging instruments. These will be available shortly after the publication of this Spotlight and can be accessed on Viewpoint. A link will be added as soon as it is available.

6. Further information

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