IFRS

STAFF PAPER

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IASB® meeting

Project	**IBOR Reform and its Effects on Financial Reporting – Phase 2**
Paper topic	End of Phase 2 amendments and voluntary versus mandatory application

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1. Purpose of this paper

1. The purpose of this paper is to discuss the end of application for the proposed amendments in Phase 2 and whether those amendments should be mandatory, or an entity should have a choice in applying them.

2. At this meeting, the staff will ask the Board to decide on the proposed end of application and mandatory or voluntary application of the proposed amendments as set out in this paper.

3. This paper is structured as follows:

    (a) Background (paragraphs 4–6);

    (b) End of application (paragraphs 7–23);

    (c) Questions 1 for the Board (page 6);

    (d) Voluntary versus mandatory application (paragraphs 24–33);

    (e) Question 2 for the Board (page 10).

2. Background

4. In September 2019, the Board discussed the replacement issues—that is, issues affecting financial reporting after the reform of an existing interest rate benchmark including its replacement with an alternative benchmark rate—to be considered in Phase 2 and the proposed order in which these issues should be discussed (project plan).

5. Following this project plan, at the subsequent meetings, the Board discussed and tentatively decided to make amendments to particular IFRS Standards to address replacement issues. Agenda paper 14 *Cover paper and summary of tentative decisions to date* for this meeting describes in more detail these tentative decisions. Agenda paper 14B *Hedges of risk components–separately identifiable requirement* for this meeting includes an additional staff recommendation for the Board to consider at this meeting and is included in the analysis on the assumption that the Board support the staff recommendation. For the purpose of this paper, we collectively refer to Board's tentative decisions as 'proposed amendments'.

6. According to the project plan, the next topic for discussion is the end of application for the proposed amendments in Phase 2 and whether those amendments should be applied voluntarily or mandatorily.

3. End of application

7. The staff note that interest rate benchmark reform is following different timelines in different jurisdictions and therefore, similar to the Phase 1 amendments, [1] defining a set period during which the proposed amendments should be applied is difficult, because, thus far, there is no universal date specifying when the market-wide reform of interest rate benchmarks will be completed.

8. However, unlike the Phase 1 amendments which are applied over the period when there is uncertainty regarding the timing and the amount of interest rate benchmark-based cash flows, the application of the proposed amendments in Phase 2 is, to a large extent, associated with the point at which transition to an

[1] As part of Phase 1 of this project, in September 2019, the Board issued *Interest Rate Benchmark Reform*, which amended IFRS 9, IAS 39 and IFRS 7

alternative benchmark rates occurs—hence by design, the application of these amendments has a limited life and a natural end of application.

9. In other words, the nature of Phase 2 amendments is such that an entity applies the proposed amendments *once* to an item—that is, upon transition from interest rate benchmarks to alternative benchmark rates including the changes to hedge documentation necessary to reflect the modifications directly required by the reform. Accordingly, an entity would not apply the proposed amendments continuously after a financial instrument has transitioned to an alternative benchmark rate.

10. The staff's analysis in the following paragraphs outlines the end of application of the proposed amendments in each of the areas that the Board discussed.

3.1 Classification and measurement of financial instruments

11. In summary, the proposed amendments to the classification and measurement requirements focus on supporting preparers in applying the modification requirements in IFRS 9 to financial instruments that are modified as a direct consequence of IBOR reform. [2] [3]

12. As stated in paragraph 9, the nature of the proposed amendments to the modification requirements is such that they can only be applied once to a financial instrument—that is, contractual cash flows of a financial instrument can change only once as a direct consequence of IBOR reform. Therefore, an entity can apply the practical expedient to account for modifications that are a direct consequence of IBOR reform and done on an economically equivalent basis (modifications directly required by the reform), only once to a financial instrument. Similarly, the proposed amendment to account for modifications directly required by the reform first before applying paragraph 5.4.3 of IFRS 9 to other modifications, is applied only once.

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[2] The detailed information on the proposed amendments on classification and measurement of financial instruments are set out in AP14 *Cover paper and summary of tentative decisions* to date for this meeting and the October 2019 IASB Update.

[3] The Board also proposed amending IFRS 4 *Insurance Contracts* to require insurers that apply the temporary exemption from IFRS 9 to apply the amendments resulting from the Board's tentative decisions in Phase 2 of the project in accounting for modifications directly required by IBOR reform

13. As a result, the application of these proposed amendments will end at the modification date of a specific financial instrument although it may end at different times for different financial instruments. Subsequently, an entity should apply the current requirements in IFRS 9 to account for any modifications to the contractual cash flows that are made after that point.

3.2 Hedge accounting

14. Following from the proposed amendments to the classification and measurement requirements in IFRS 9, the Board proposed amendments to the hedge accounting requirements in IFRS 9 and IAS 39 *Financial Instruments: Recognition and Measurement* to permit an entity to not discontinue hedge accounting when making changes to the hedging relationship and related hedge documentation necessary to reflect modifications directly required by the reform. [4]

15. Accordingly, similar to the proposed amendments on classification and measurement of financial instruments, the staff is of the view that an entity will apply the exceptions to the hedge accounting requirements at the date that the changes to the hedging relationship and related hedge documentation are made to reflect the modifications directly required by the reform. Once those changes are done, the entity would no longer apply the proposed amendments and the subsequent accounting will follow the current requirements in IFRS Standards.

16. The staff however, envisage that there could be situations whereby more than one change in hedge documentation may be necessary to reflect modifications directly required by the reform. For example, an entity may first modify a derivative that has been designated as a hedging instrument, while the modification of the financial instrument designated as the hedged item is only done at a later date. In applying the Phase 2 amendments, the entity will amend the hedging relationship and hedge documentation to reflect the fact that the hedging instrument is now referenced to an alternative benchmark rate. At the later date, when the hedged item is modified, the hedging relationship may be amended again, and the hedge

[4] For detailed information on the Board's tentative decisions for Phase 2 on hedge accounting refer to AP14 for this meeting or December 2019 IASB Update and January 2020 IASB Update.

documentation updated to reflect the change in the hedged risk and/or the hedged item.

17. Although the hedging relationship and related documentation are updated at different points in time, the proposed amendments are only applied once to each element in the hedging relationships. Therefore, we would not expect an entity to continue applying the proposed amendments to changes made to the hedging relationship and related hedge documentation after it has done so to reflect the modifications directly required by the reform.

18. Similarly, the proposed amendment to require, for the purpose of the retrospective assessment in IAS 39, that the cumulative fair value changes be reset to zero, only applies at the date the exception to the retrospective assessment in paragraph 102G of IAS 39 ceases to apply.

3.3 Lessee accounting

19. The proposed amendment for lessee accounting applying IFRS 16 *Leases* is similar in nature to the proposed amendment to IFRS 9 for the modification of financial instruments. As such the staff think that a similar analysis as described in paragraphs 11-13 also apply in the context of end of application for the proposed amendment for lessee accounting.

20. In other words, an entity would only apply the proposed amendment to a lease modification that is directly required by the reform once, at the date that the lease payments are modified. Subsequently, an entity applies the current requirements in IFRS 16 to account for modifications of the lease payments.

3.4 Disclosures

21. Given the objective of the proposed disclosure requirements, the staff is of the view that an entity should be required to provide this information in a reporting period during which:

    (a) the entity is exposed to risks arising from interest rate benchmark reform; and/or

(b) the entity's transition to alternative benchmark rates for all financial instruments and hedging relationships affected by IBOR reform has not been completed yet.

3.5 Hedges of risk components—separately identifiable requirement

22. If the Board agrees with the staff recommendation in Agenda Paper 14B for this meeting, the proposed amendments will include a temporary relief so that an entity is able to designate an alternative benchmark rate as a separately identifiable risk component if there is a reasonable expectation that the alternative benchmark rate will satisfy the separately identifiable requirement in a particular market structure within 12 months of being designated as a risk component for hedge accounting purposes and the component can be reliably measured from the date it is designated as the risk component.

23. The staff is therefore is of the view that the proposed amendment with respect to the separately identifiable requirement for risk components, will cease to apply 12-months after the date that the alternative benchmark rate was designated as a risk component for hedge accounting purposes.

Questions for the Board

Question 1 for the Board
1) Does the Board agree with the staff analysis set out in paragraphs 11-23 about the end of application of the proposed amendments in Phase 2?

4. Voluntary versus mandatory application

24. For the purpose of Phase 1 amendments, the Board decided to *require* entities to apply the relevant exceptions to all hedging relationships that are directly affected by the uncertainties arising from the interest rate benchmark reform and continue to apply those exceptions until required to cease their application as specified in paragraphs 6.8.9–6.8.12 of IFRS 9 or 102J–102N of IAS 39.

25. As noted in paragraphs BC6.581 of IFRS 9 and BC267 of IAS 39, when deliberating Phase 1 amendments, the Board considered but rejected alternatives that would have allowed entities to apply the exceptions voluntarily. In the Board's view, voluntary application of these exceptions could give rise to selective discontinuation of hedge accounting because of IBOR reform and selective reclassification of the amounts recorded in other comprehensive income related to previously discontinued hedging relationships.

26. Similarly for Phase 2, in staff's view, voluntary application of the proposed amendments could lead to selective application of the proposed amendments to some financial instruments but not others or could apply to some areas included in the scope of proposed amendments (eg classification and measurement of financial instruments) but not to other areas (eg lessee accounting).

27. Furthermore, similar to Phase 1, the staff is concerned that voluntary application could provide opportunities for structuring. This would allow entities to elect not to apply the proposed amendments to specific financial instruments or hedging relationships solely to achieve an accounting outcome that does not reflect the economic effects of interest rate benchmark reform or reflect the entity's risk management strategy. For example, choosing not to apply the proposed amendments to certain financial instruments or hedging relationships solely to achieve targeted accounting outcomes (eg recognising a gain or loss associated with the discontinuation of hedge accounting).

28. The staff note that such a choice of applying the proposed amendments, among other consequences, would distort the usefulness of the information to users of financial statements about the effects of IBOR reform, reduce comparability of financial statements and hence be inconsistent with the objective of Phase 2—that is, to provide useful information to users of financial statements about the effects

of the transition to alternative benchmark rates on an entity's financial statements and support preparers in applying the requirements of IFRS Standards during IBOR reform.

29. The staff also note that the areas addressed in Board's tentative decisions in Phase 2 are, to a large extent, linked to one another and hence they need to apply consistently. For example, an entity applying the proposed amendments on classification and measurement of financial instruments would need to also apply the proposed amendments in hedge accounting because of their interdependency—that is, some of the proposed amendments to the hedge accounting requirements in IFRS 9 and IAS 39 address changes in hedging relationships and hedge documentation that are necessary to reflect the modifications directly required by the reform.

30. For the reasons described above, the staff is therefore of the view that the proposed amendments for Phase 2, should apply mandatorily. In other words, an entity would not be able to choose whether to apply the proposed amendments and its application would be irrevocable. This would address the concerns described in paragraphs 26-29 and would be consistent with the Board's decision for mandatory application of Phase 1 amendments as well as for the *Novation of Derivatives and Continuation of Hedge Accounting* (Amendments to IAS 39 and IFRS 9).

31. The staff do not consider that mandatory application of the proposed amendments represents significant additional costs for preparers and other affected parties. This is based on the following considerations:

    (a) the Phase 2 proposed amendments are applied upon transition to alternative benchmark rates. As part of preparation to transition to alternative benchmark rates, an entity would have done a comprehensive review of items including financial instruments, hedging relationships and lease contracts that are affected by interest rate benchmark reform to determine the appropriate transition process. Therefore, an entity would be able to identify the items subject to mandatory application of the proposed amendments.

(b) the proposed amendments are designed to ease the operational burden on preparers and other affected parties, while continuing to provide useful information to users of financial statements through additional disclosure requirements.

(c) the Board tentatively decided that an entity should provide objective-based disclosures about the transition to alternative benchmark rates. As discussed at that Board meeting, the staff do not consider the cost and effort to preparers to provide the disclosures to outweigh the benefits to the users of the financial statements because they are primarily qualitative in nature and focus on the nature and extent of risks arising from IBOR reform and the entity's progress in completing the transition to alternative benchmark rates. The staff would envisage that, to a large extent, entities prepare this information already for internal or regulatory reporting purposes.

32. The staff would also like to clarify that, consistent with the Board's observations in paragraph BC6.583 of IFRS 9 and BC269 of IAS 39 for Phase 1 amendments, for a particular hedging relationship the relevant proposed amendments may be applicable to some but not all aspects of the hedging relationship at the same time. For example, if an entity designates a hedged item that is based on IBOR against a hedging instrument that is being modified to reference an alternative benchmark rate (assuming the entity can demonstrate that hedging relationship meets the qualifying criteria for hedge accounting in IFRS 9 or IAS 39), the relevant proposed amendments in Phase 2 would apply to the hedging instrument because it falls in the scope of Phase 2. In this scenario, the relevant Phase 1 amendments would apply for the hedged item because there is uncertainty about the interest rate benchmark-based cash flows (ie IBOR-based cash flows).

Staff recommendation

33. Based in our analysis as set out in paragraphs 24-32, the staff recommend that the proposed amendments should apply mandatorily.

Question for the Board

Question 2 for the Board
2) Does the Board agree with the staff recommendation in paragraph 33 that all proposed amendments in Phase 2 should apply mandatorily?