No. 2021-01
Updated 8 June 2023

Technical Line

FASB — final guidance

A closer look at the FASB accounting relief related to reference rate reform

Revised 8 June 2023

In this issue:

What you need to know

- The reference rate reform guidance in ASC 848 provides temporary optional expedients and exceptions to the US GAAP guidance on contract modifications and hedge accounting to ease the financial reporting burdens related to the transition away from LIBOR and other rates that are being discontinued.
- Under this guidance, entities can elect not to apply certain modification accounting requirements to contracts affected by reference rate reform, if certain criteria are met. Entities that make this election would not have to remeasure the contracts at the modification date or reassess any accounting determinations.
- Entities also can elect to apply various optional expedients and exceptions to the hedge accounting requirements in ASC 815 for hedging relationships affected by reference rate reform, if certain criteria are met.
- Entities may make a one-time election to sell and/or reclassify held-to-maturity debt securities that reference an interest rate affected by reference rate reform.
- The sunset date for applying the reference rate relief in ASC 848 was extended to 31 December 2024 from 31 December 2022.

Overview

Accounting Standards Codification (ASC or Codification) 848, *Reference Rate Reform*,[1] provides temporary optional expedients and exceptions to certain guidance in US GAAP to ease the financial reporting burdens related to the market transition from the London Interbank

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Offered Rate (LIBOR) and other interbank offered rates (IBORs) to alternative reference rates, such as the Secured Overnight Financing Rate (SOFR). The initiative to transition from IBORs to alternative rates is often referred to as reference rate reform.

This guidance simplifies the accounting for the modification of all types of contracts (e.g., debt instruments, derivatives, leases) that refer to LIBOR or other IBORs that are being discontinued due to reference rate reform.

The guidance also enables entities to continue to apply hedge accounting to hedging relationships affected by reference rate reform, if certain criteria are met. Entities are also able to elect various optional expedients intended to simplify the application of hedge accounting during the transition.

In addition, the guidance allows entities to make a one-time election to sell and/or transfer to available for sale or trading any held-to-maturity (HTM) debt securities that refer to an interest rate affected by reference rate reform and were classified as HTM before 1 January 2020.

Since it issued the guidance in 2020, the Financial Accounting Standards Board (FASB or Board) has monitored global reference rate reform to determine whether further improvements to the guidance were needed.

The guidance in ASC 848 helps facilitate the market transition from existing reference interest rates to alternative rates.

In 2021, the FASB issued Accounting Standards Update (ASU) 2021-01[2] to clarify that all derivative instruments affected by changes to the interest rates used for discounting, margining or contract price alignment (commonly referred to as the discounting transition) are in the scope of ASC 848. The amendments in ASU 2021-01 also clarified other aspects of the guidance in ASC 848 and addressed the effects of the cash compensation adjustment provided in the discounting transition on certain aspects of hedge accounting.

In 2022, the FASB issued ASU 2022-06[3] to extend the sunset date in ASC 848 to 31 December 2024 from 31 December 2022. This was done in response to the decision by the United Kingdom's Financial Conduct Authority and the administrator of LIBOR to extend the period through which the overnight, one-, three-, six- and 12-month USD LIBOR settings would be published from 31 December 2021 to 30 June 2023.

Because the relief provided by ASC 848 was intended to help facilitate the transition away from LIBOR and certain other reference rates, it is temporary in nature and cannot be applied to contract modifications that occur after the sunset date or hedging relationships entered into after that date. The relief also cannot be applied to hedging relationships evaluated after the sunset date, except for certain expedients entities can continue to use for the remaining life of a hedge.

However, most entities will stop applying the guidance before the sunset date since they will have completed the transition away from LIBOR or other discontinued rates and, therefore, the criteria to apply the relief will no longer be met.

This Technical Line has been updated to reflect the new sunset date and to provide interpretative guidance on how entities may determine the terms of the hypothetical derivative when they are no longer applying the relief for assessing hedge effectiveness in ASC 848.

Background

Historically, LIBOR and other IBORs were used extensively in the US and global markets as reference interest rates in a broad range of financial instruments and commercial agreements. However, the reliability of these benchmark interest rates has been called into question. In 2014, the Financial Stability Board published a report setting out recommendations to reform some of the major interest rate benchmarks, including LIBOR. Since then, regulators and public authorities from various jurisdictions have been working to replace LIBOR and other IBORs with reference interest rates that are supported by transactions in liquid and observable markets and are, therefore, less susceptible to manipulation.

As a result, LIBOR and certain other widely used reference rates have been, or are expected to be, discontinued. Markets have been preparing for the transition to alternative reference rates, such as SOFR in the US and the Sterling Overnight Index Average Rate (SONIA) in the UK.

In 2018, the FASB added[4] the overnight index swap (OIS) rate based on SOFR to the list of US benchmark interest rates that are eligible to be hedged. This move was seen as an important step to help broaden the acceptance of this rate in the marketplace.

In 2020, CME Group Inc. and LCH Group switched to using SOFR from the Effective Fed Funds Rate (EFFR) to discount, margin and determine the price alignment amount (PAA) for most of their US-dollar discounted products.[5] More recently, centrally cleared USD LIBOR-based swaps were converted to SOFR-based swaps.

Scope

The guidance in ASC 848 applies to contracts and other transactions that refer to LIBOR or other reference rates that are expected to be discontinued due to reference rate reform (collectively referred to as eligible reference rates).

In addition, as noted above, the FASB amended the scope of the guidance to clarify that entities can apply certain optional expedients to derivatives affected by the discounting transition even though they do not reference LIBOR or another rate expected to be discontinued as a result of reference rate reform. The amendments were made to address concerns raised by certain constituents about whether changing the rates used to discount, margin and determine the PAA for these instruments would result in (1) a modification of the derivative that would require a reassessment of previous accounting determinations (e.g., whether the instrument is still a derivative in its entirety or a hybrid instrument) or (2) a change in the critical terms that would require dedesignation of any hedging relationship where the affected derivative was designated as the hedging instrument.

The Board did this because it did not believe that reassessing the accounting conclusions for these instruments would result in better financial reporting or provide decision-useful information to users of financial statements.

Eligible reference rates

All maturities of LIBOR in all jurisdictions and currencies are considered to be eligible reference rates. In addition, ASC 848-10-15-4 provides the following indicators to help entities determine when a reference rate other than LIBOR is expected to be discontinued and can, therefore, be considered an eligible reference rate under the scope of ASC 848.

Expectation that a reference rate may be discontinued may result from:		
A public statement or publication of information by or on behalf of the administrator of the relevant reference rate or by the regulatory supervisor for the administrator	Initiatives by a significant number of market participants or by market participants representing a significant number of transactions to move away from the reference rate	The production method for the calculation of the published reference rate is either: ▸ Fundamentally restructured ▸ Reliant on another rate that is expected to be discontinued

Any contract or transaction that references LIBOR or another eligible reference rate broadly falls within the overall scope of ASC 848. However, additional criteria must be met in order for an entity to elect to apply the optional expedients and exceptions to the US GAAP requirements on contract modifications, hedge accounting and sales/transfers from held-to-maturity classification. These additional criteria are discussed in the sections below.

A contract modification must meet the criteria in ASC 848 to be eligible for relief from certain modification accounting requirements.

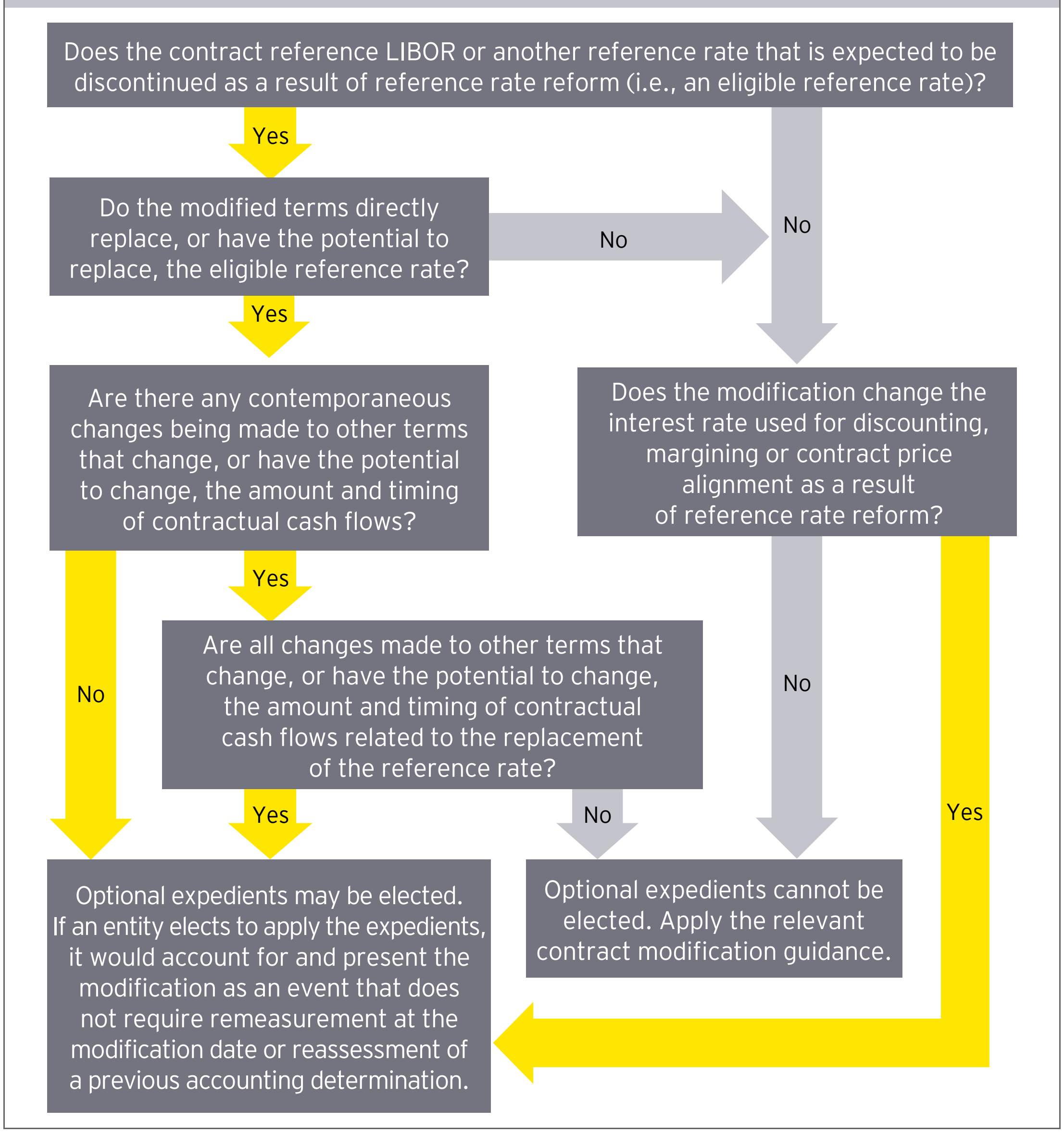
How we see it

Entities that elect to apply the relief in ASC 848 to contracts and transactions that refer to an eligible reference rate other than LIBOR should document why they believe those reference rates are expected to be discontinued.

Contract modifications

The guidance in ASC 848 allows an entity to elect not to apply certain modification accounting requirements to contracts affected by reference rate reform, if certain criteria are met. The following decision tree illustrates how an entity would evaluate whether a modified contract qualifies for this relief:

Illustration 1 — Contract modification relief decision tree



Eligibility of modified contracts

As illustrated above, for contracts that reference LIBOR or another reference interest rate that is expected to be discontinued due to reference rate reform (i.e., the contract references an eligible reference rate), entities can elect relief from certain modification accounting requirements in US GAAP if the modified contracts meet either or both of the following additional criteria:

- The modified terms directly replace or have the potential to replace an eligible reference rate due to reference rate reform, and any contemporaneous changes to other terms (i.e., those that don't directly replace or have the potential to replace a reference rate) that change or have the potential to change the amount or timing of contractual cash flows are related to the replacement of a reference rate.
- The interest rate used for discounting, margining or contract price alignment is modified as a result of reference rate reform.

For contracts that do not reference an eligible reference rate, the contract modification relief can only be applied when the rate used for discounting, margining or contract price alignment is changed as a result of reference rate reform.

How we see it

While this is not stated in the guidance, we generally believe the modification accounting relief would not apply to a derivative contract that is affected by the discounting transition but doesn't reference an eligible reference rate if contemporaneous changes are made to other terms that change or have the potential to change the amount or timing of contractual cash flows.

For example, we believe the relief would not apply if counterparties to a derivative instrument that is not centrally cleared agreed to change the notional amount or maturity date of the instrument contemporaneously with changing the rate used for discounting and determining the collateral and the interest paid on collateral.

A modification that is intended to change the eligible reference rate to an alternative rate may involve directly replacing the eligible rate in the contract with an alternative rate (e.g., by changing the terms of a three-month LIBOR-based variable-rate debt instrument so that all future interest payments would be indexed to SOFR or the Prime Rate) or by making changes to the contractual terms, such as adding or amending provisions in the fallback language, that have the potential to replace the eligible rate in the future.

Fallback language refers to the provisions in a contract that lay out how a replacement rate can be identified if the existing reference rate in a contract is not available. That is, the fallback language in a contract essentially acts as a how-to guide for identifying replacement rates if the original interest rate referenced in the contract were to become unavailable.

Amending the fallback language or adding fallback language to a contract would be a change that has the *potential* to replace an eligible reference rate, not a direct replacement of an eligible reference rate.

While the relief is primarily focused on contract modifications needed to replace eligible reference rates with alternative rates, the Board understood that as a result of reference rate reform, entities may need or want to change other contractual terms when modifying a contract to amend the reference rate. For example, when modifying a variable-rate debt instrument to change the reference interest rate from LIBOR to SOFR, an entity may want to also add an out-of-the money floor to the contract.

Under ASC 848, entities may elect to apply the relief to modified contracts where, in addition to changes that directly replace (or have the potential to replace) the reference rate, modifications are contemporaneously made to other terms that change (or have the potential to change) the amount or timing of contractual cash flows, as long as these other changes are deemed to be related to the replacement of the reference rate.

The guidance includes examples of changes to contractual terms that would be considered related to the replacement of a reference rate and those that generally would not. Refer to the section below on *Changes to terms considered related and unrelated to the replacement of a reference rate* for a discussion of these examples.

It should be noted that any contemporaneous changes made to contractual terms that do not change or have the potential to change the amount or timing of contractual cash flows would not preclude an entity from applying the contract modification relief in ASC 848, regardless of whether those changes are related to reference rate reform.

Changes to terms considered related and unrelated to the replacement of a reference rate

ASC 848 indicates that changes to terms that are related to the replacement of the reference rate are those that are made to effect the transition for reference rate reform and are not the result of a business decision that is separate from or in addition to changes to the terms of a contract to effect that transition. In addition to this broad principle, ASC 848-20-15-5 and 848-20-15-6 provide a list of examples of changes to contractual terms that are considered related to the replacement of an eligible reference rate and those that are generally considered unrelated. These examples are summarized below.

Changes to terms related to replacement of a reference rate	**Changes to terms unrelated to replacement of a reference rate**
‣ Changes to the referenced interest rate index ‣ Addition of or changes to a spread adjustment (e.g., adding or adjusting a spread to an interest rate index, amending the fixed rate in an interest rate swap or paying/receiving cash as compensation for the difference in reference rates) ‣ Changes to the reset period, reset dates, day-count conventions, business-day conventions, payment dates, payment frequency and repricing calculation ‣ Changes to the strike price of an existing interest rate option (including an embedded interest rate option) ‣ Addition of an interest rate floor or cap that is out of the money on the basis of the spot rate at the time of the amendment of the contract ‣ Addition of a prepayment option for which exercise is contingent upon the replacement reference interest rate index not being determinable in accordance with the terms of the agreement ‣ Addition of or changes to contractual fallback terms that are consistent with fallback terms developed by a regulator or by a private-sector working group convened by a regulator	‣ Changes to the notional amount ‣ Changes to the maturity date ‣ Changes from a referenced interest rate index to a stated fixed rate ‣ Changes to the structure of loan, such as from a term loan to a revolver ‣ The addition of an underlying or variable unrelated to the referenced rate index ‣ The addition of an interest rate floor or cap that is in the money on the basis of the spot rate at the time of the amendment of the contract ‣ A concession granted to a debtor experiencing financial difficulty ‣ The addition or removal of a prepayment or conversion option except for the addition of a prepayment option for which exercise is contingent upon the replacement reference interest rate index not being determinable in accordance with the terms of the agreement ‣ The addition or removal of a feature that is intended to provide leverage ‣ Changes to the counterparty, except in accordance with ASC 815-20-55-56A, 815-25-40-1A and 815-30-40-1A

Changes to terms related to replacement of a reference rate	Changes to terms unrelated to replacement of a reference rate
‣ Changes to terms that are necessary to comply with laws or regulations or to align with market conventions for the replacement rate (including those in ASC 848-20-15-6)	‣ Changes to the priority or seniority of an obligation in the event of a default or a liquidation event ‣ The addition or termination of a right to use one or more underlying assets in a lease contract ‣ Changes to renewal, termination or purchase option provisions in a lease contract

The examples provided in ASC 848-20-15-5 and 15-6 are not intended to be an exhaustive list of all the changes to terms that may be considered *related to* and *unrelated to* the replacement of a reference rate. In addition, the Board acknowledged that there could be instances where a changed term that is included in the list of "unrelated" changes in ASC 848-20-15-6 would be considered a "related" change because it is necessary to comply with laws or regulations or to align with market conventions for the replacement rate.

For instance, a change to the maturity date of a contract (e.g., extending the maturity date of a loan) is included in ASC 848-20-15-6 as an example of a change in terms that would generally be considered unrelated to the replacement of the reference rate, because the Board believes this would typically require a new business decision by one or both of the counterparties to the contract (i.e., a new credit decision by the lender). However, a change to the maturity date of a contract by a few days due to structural changes in the contract as a result of reference rate reform (e.g., a change in payment dates or day-count conventions) could be considered related to the replacement of the reference rate. Entities should apply judgment when considering whether a change in contractual terms relates to the replacement of a reference rate.

How we see it

While the examples provided in ASC 848 serve as helpful guidance, judgment may still be required in certain cases to determine whether a modified contract is eligible for the relief provided in ASC 848. This may be the case when, for example, a spread to an interest rate index in the contract is added or adjusted.

Such a modification is expected to be fairly common given the basis difference that may exist between the old and new reference rates (e.g., between LIBOR and SOFR) and would generally be considered a change in terms that relates to the replacement of a reference rate. However, such a change would not be considered related to the replacement of a reference rate if the spread was added or adjusted primarily because the credit risk of one of the counterparties to the contract had significantly changed since the inception of the contract.

Additional judgment may be needed when multiple terms that change or have the potential to change the amount or timing of contractual cash flows of a contract are modified.

Changes to contractual fallback language

Historically, when fallback language was included in contracts, it only contemplated situations in which a reference rate might be temporarily unavailable. That is, the language was not intended to address the permanent discontinuation of a reference rate. As a result, various industry groups worked to develop robust fallback provisions that may be added to or may replace existing language in contracts that reference IBORs. Given the need for many contracts to be modified to add or amend fallback terms, ASC 848 provides specific guidance on this issue.

ASC 848-20-15-7 states that amending or adding contractual fallback terms to make them consistent with fallback terms developed by a regulator or a private-sector working group convened by a regulator are presumed to be changes related to reference rate reform. As noted by the Board in paragraph BC31 of the Background Information and Basis for Conclusions of ASU 2020-04, this would include incorporating fallback terms that are qualitatively determined to be substantially similar to the fallback terms developed by a regulator or private-sector working group convened by a regulator. The Alternative Reference Rates Committee (ARRC) and the International Swaps and Derivatives Association (ISDA)[6] are examples of private-sector working groups.

If an entity adds or changes contractual fallback terms in a manner that is not consistent with fallback terms developed by a regulator or a private-sector working group convened by a regulator, the entity may still qualify to apply the contract modification relief in ASC 848. However, the entity would need to determine whether the new or modified fallback terms include or have the potential to include a term that is unrelated to reference rate reform.

If such a term were included, the entity would be precluded from applying the relief unless it determines at the time the fallback terms are added or changed that the unrelated term is not probable of occurring if the fallback terms are triggered. This might be the case if the new or revised fallback terms include a predefined sequence of rates to replace the current reference rate upon its discontinuation, and the last rate in the sequence is a stated fixed rate.

As discussed in the section below, a contract modification that directly replaces a reference rate index with a stated fixed rate is generally considered a change that is unrelated to reference rate reform. Nevertheless, the entity could choose to apply the relief to this modified contract if it determines that it is not probable that the stated fixed rate will be the actual replacement rate used when the fallback terms are triggered, given that it is the last rate in the predefined sequence.

Replacing a discontinued reference rate with a stated fixed rate

ASC 848 states that a contract modification that directly replaces a referenced interest rate index with a stated fixed rate is considered a change that is unrelated to reference rate reform. As discussed in paragraph BC30 of the Basis for Conclusions of ASU 2020-04, the Board determined that change from a variable-rate exposure to a negotiated stated fixed rate in a debt or derivative instrument could include components that reflect a business decision that is separate from or in addition to changes to the terms of a contract to effect the transition for reference rate reform.

However, the guidance in ASC 848-20-15-9 clarifies that a change to the last published rate of a discontinued interest rate index is not considered a change to a stated fixed rate. For example, if a contract is modified to reference the last published LIBOR rate prior to LIBOR's discontinuation, this is not considered to be a change that is an unrelated to reference rate reform.

In addition, the guidance in ASC 848-20-15-10 explains that if a contract has existing fallback terms that would replace a discontinued reference rate with a stated fixed rate, a modification to those fallback terms to replace the stated fixed rate with a new interest rate index would be considered a change that is related to the replacement of a reference rate.

An entity may elect not to remeasure a contract at the modification date or reassess previous accounting determinations if the criteria in ASC 848 are met.

Timing of modifications

ASC 848 allows entities to make modifications to a contract in anticipation of the discontinuance of an eligible reference rate. This means that entities can apply the contract modification relief to in-scope modifications made to contracts before the eligible reference rates are discontinued to manage the transition to alternative reference rates. For example, many centrally cleared USD LIBOR-based swaps were converted to SOFR-based swaps in April 2023, prior to the 30 June 2023 discontinuation date for the remaining USD LIBOR settings.

In addition, entities may apply the relief to in-scope contracts that will mature before the eligible rate referenced in the contract is expected to be discontinued.

Optional expedients for contracts modified due to reference rate reform

For contract modifications that meet the criteria noted above, entities can elect to apply expedients that provide relief from certain requirements in US GAAP, including the requirement to evaluate whether a modification results in the establishment of a new contract or the continuation of an existing contract. This relief allows an entity to account for and present a modification as an event that does not require contract remeasurement at the modification date or reassessment of a previous accounting determination. That is, the modified contract is accounted for and presented as a continuation of the existing contract.

The implementation guidance in ASC 848-20-55-2 provides the following examples of how applying the contract modification relief would affect contracts accounted for under various ASC topics. These examples are not intended to be all inclusive.

Contracts/instruments modified due to reference rate reform	Effect of applying contract modification relief
Instruments accounted for as derivatives under ASC 815, *Derivatives and Hedging*	An entity does not reassess whether the modified instrument is a hybrid instrument and whether it includes a significant financing element under ASC 815-10-45-11 through 45-15. The modified instrument is accounted for and presented in the same manner as the instrument was before the modification.
Contracts issued by insurance entities accounted for in accordance with ASC 944, *Financial Services — Insurance*	An entity does not reassess whether the modified contract is substantially unchanged under ASC 944-30. The modified contract is accounted for and presented as a continuation of the existing contract.
Contracts accounted for in accordance with ASC 606, *Revenue from Contracts with Customers*	An entity does not reassess the contract under ASC 606-10-25-10 through 25-13. Cash flow changes resulting from variability in the new reference rate should be accounted for and presented in the same manner as those that resulted from variability in the reference rate before the modification.
Contracts with a counterparty entity in the scope of the variable interest entity (VIE) guidance in ASC 810, *Consolidation*	An entity does not reconsider the determination of the counterparty entity's VIE status under 815-10-35-4.

Specific guidance

ASC 848 also provides guidance for modified contracts that are accounted for under ASC 310, ASC 470, ASC 815 and ASC 842.[7] Based on its outreach to stakeholders, the FASB determined that contracts accounted for under these topics would represent a significant number of the contract modifications expected to be made as result of reference rate reform. Accordingly, the Board decided to include guidance for these items that would be easily understandable in the context of the requirements for each topic. The relief provided for each topic is summarized below.

ASC topic	Relief
ASC 310, *Receivables,* or ASC 470, *Debt*	An entity accounts for the contract as if the modification were only minor (ASC 310-20) or not substantial (ASC 470-50). As a result, the modification is accounted for by prospectively adjusting the effective interest rate in the agreement.
ASC 842, *Leases*	An entity does not reassess lease classification and the discount rate, remeasure lease payments or make other reassessments or remeasurements. In addition, lessees do not remeasure the lease liability. The lease is accounted for as a continuation of the existing contract.
Embedded derivatives in the scope of ASC 815, *Derivatives and Hedging — Embedded Derivatives*	An entity does not reassess its conclusion about whether the contract contains an embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract under ASC 815-15-25-1(a).

Debt exchanges or modifications within a year of the current modification

When multiple modifications are made to a debt instrument within a year of the transaction being assessed, ASC 470-50-40-12(f) requires the aggregate changes to be considered when applying the 10% cash flow test in ASC 470-50-40-10 to determine whether the debt instrument is substantially different after a modification or debt exchange.

However, the guidance in ASC 848 makes it clear that if an entity applies the contract modification relief to a debt instrument accounted for under ASC 470 and within a year makes a subsequent modification to the same contract (where the 10% cash flow test is applied), the entity would only consider the terms and provisions that were in effect immediately following the modification to which the relief was applied.

Amendments to lease contracts accounted for under ASC 842

The guidance in ASC 848 provides entities with an optional expedient to not apply the lease modification accounting requirements in ASC 842 to lease contracts affected by reference rate reform, if the relevant criteria discussed in the *Eligibility of modified contracts* section are met.

Under ASC 842, a change in the index or rate on which lease payments are based would be accounted for as a lease modification because it will result in a change in the consideration for the lease. A lease modification generally requires (1) the remeasurement and reallocation of consideration in the contract, (2) reassessment of lease term, discount rate and lease classification and (3) for lessees, remeasurement of the right-of-use (ROU) asset and the lease liability.

However, if a modified lease contract accounted for under ASC 842 meets the criteria described earlier, and the entity elects to apply the optional expedient in ASC 848, the entity would not account for the change in the lease contract as a lease modification.

In deciding to provide this relief, the Board determined that the expected costs to preparers of following the lease modifications requirements in US GAAP would outweigh the potential benefits to users. However, if contemporaneous changes are made to other terms in the lease contract that change or have the potential to change the amount or timing of contractual cash flows, the optional expedient may only be applied if those changes are related to the replacement of the reference rate. For example, a change to the lease term that is made concurrently with a change in the rate in which lease payments are based would generally disqualify an entity from applying the relief from modification accounting to that lease because the change in lease term is considered to be unrelated to reference rate reform.

Embedded derivatives

If the relief is applied to a contract that is changed due to reference rate reform, the entity does not have to reassess its original conclusion about whether the contract contains an embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract in accordance with ASC 815-15.

The Board determined that, for purposes of this guidance, not requiring an entity to reassess its conclusion regarding whether a contract contains an embedded derivative that needs to be bifurcated would reduce expected costs for preparers and would not affect the usefulness of financial reporting.

How we see it

Some market participants have raised questions about the how the embedded derivative guidance in ASC 815 should be applied to new contracts that reference SOFR, including whether certain interest rate reset features in these contracts would meet the definition of an embedded derivative requiring bifurcation.

In response to an inquiry from the ARRC, the Securities and Exchange Commission (SEC) staff stated that it did not object to the ARRC's view that the various SOFR interest rate reset features described in the inquiry were terms of the host contract and did not represent embedded derivatives that required further assessment of bifurcation under the embedded derivatives guidance.

The ARRC's inquiry included interest rate reset conventions based on term SOFR (i.e., SOFR for a specified period of time greater than overnight), compounded SOFR "in-arrears," compounded SOFR "in-advance" and average SOFR "in-advance." The ARRC expressed the view that these interest rate reset features are normal market conventions that could be viewed as terms of the host contract and, therefore, did not represent embedded derivatives requiring further assessment (i.e., they would not be subject to the "double-double" test in ASC 815-15-20-26(b)).

The ARRC highlighted that these SOFR-based reset features are intended to provide a market-based solution to the discontinuation of LIBOR and are not meant to provide leveraged returns to investors. In addition, the ARRC noted that certain of the features will be required for specific products because, under consumer protection laws, advance notice of interest rate changes must be provided to borrowers.

The SEC staff said its conclusion was based on expectations that existed at the time of the ARRC's inquiry as to how markets for certain SOFR-based products would develop and noted that entities would need to evaluate any new interest rate features as markets continue to develop and changes in factors or circumstances occur.

Consistent application

If an entity elects the relief in ASC 848 for one of its contract modifications, it must apply the expedient to all eligible contracts that are accounted for under the same Codification topic or industry subtopic. For example, if an entity elects the optional expedient under ASC 848 for modifications of leases accounted for under ASC 842 that reference LIBOR, it must apply that expedient consistently to all eligible modified leases accounted for under ASC 842. Similarly, if an entity applies the relief to the modification of a contract accounted for in accordance with a particular Codification topic (e.g., ASC 310), the entity must also apply the relief to all modifications accounted for under the related industry subtopic (e.g., ASC 944-310).

The Board provided one exception to this requirement for derivative instruments where the rate used for discounting, margining or contract price alignment is changed. The guidance in ASC 848-20-35-1 indicates that an entity's election to apply the contract modification relief to these derivative instruments is considered to be separate from its election to apply the relief when accounting for other derivative contract modifications.

How we see it

Entities should have processes and controls over identifying contracts affected by reference rate reform that will be (or were) modified to make sure the optional expedients have been applied appropriately and consistently.

Hedge accounting

ASC 848 provides various optional expedients that may be applied to hedging relationships affected by reference rate reform, if certain criteria are met. Certain expedients apply to all types of hedging relationships, while others apply specifically fair value, cash flow or net investment hedges.

In general, the expedients minimize the effect of the market-wide transition away from LIBOR and other IBORs on existing hedging relationships since they allow hedge accounting to continue uninterrupted and make it easier to apply the requirements to maintain hedge accounting during the transition period.

The optional expedients related to hedge accounting can generally be applied if the hedging instrument, hedged item or hedged forecasted transaction references LIBOR or another eligible reference rate and the modifications made to the hedging relationship are related to the replacement of a reference rate as discussed in ASC 848-20-15-2 through 15-3.

Certain expedients can only be applied when either the hedging instrument or the hedged item/forecasted transaction references a rate that will be discontinued. That is, the relief can only be applied during the transition period when there is a mismatch between the referenced interest rate index on the hedging instrument and the rate in the hedged item/forecasted transaction, which could occur when these instruments are modified at different times.

Other expedients can only be applied when both the hedging instrument and the hedged item/forecasted transaction reference a rate expected to be discontinued. That is, the relief no longer applies once the reference rate in either the hedging instrument or hedged item has been modified.

In addition, the FASB expanded the scope of ASC 848 to allow certain optional expedients related to hedge accounting to be applied to hedging relationships where the derivative that serves as the hedging instrument does not reference LIBOR or another rate expected to be discontinued as a result of reference rate reform. These expedients can be applied when the interest rate used for discounting, margining or determining the contract price alignment amount of a hedging derivative is changed (i.e., the hedging derivative is affected by the discounting transition).

Consistency of application

The optional expedients related to hedge accounting can be applied on an individual hedge and individual expedient basis. That is, an entity can decide which optional expedients to apply on a hedge-by-hedge basis, and it can apply an optional expedient for some hedging relationships but not for other similar hedging relationships.

In addition, an entity can elect to apply only certain of the hedge accounting optional expedients that relate to a specific type of hedging relationship. Further, if an entity elects to apply multiple optional expedients to a single hedging relationship, it can do so in different reporting periods.

The optional expedients related to hedge accounting can be elected on a hedge-by-hedge basis.

How we see it

Given the nature of the relief, entities may choose to apply different hedge accounting optional expedients at different times. For example, certain expedients provide relief that is needed before any modifications are made, while others are not relevant until the modification is made.

From an operational standpoint, entities may want to document certain elections broadly, so that their intent to apply the expedient when needed is clear. For example, an entity could broadly document its decision to apply certain expedients to all hedging relationships where the critical terms of the hedging instrument or hedged item are modified due to reference rate reform. While the individual hedge documentation may need to be updated for the change in term (as noted in ASC 848-20-25-4), such an approach would eliminate any doubt regarding the entity's intent to apply the relief at the time the change is made.

Entities may choose to apply certain optional expedients for all similar hedging relationships. However, if different elections are made for different hedges, the entity should clearly document the expedients that are applied to each hedging relationship.

Optional expedients that can be applied to all types of hedges

Under ASC 815, hedge accounting is generally discontinued if the critical terms of a hedging relationship are modified. When this occurs, an entity needs to dedesignate the original hedge and redesignate a new hedging relationship, creating additional complexity and potential earnings volatility. To avoid this outcome, the FASB provided various optional expedients that allow an entity not to dedesignate a hedging relationship if the critical terms are modified as a result of reference reform.

The optional expedients that may be applied to all types of hedging relationships that are in the scope of the guidance are summarized below.

Optional expedients for all types of hedging relationships (fair value, cash flow and net investment hedges)

Changes to the critical terms of a hedging instrument, hedged item or forecasted transaction

- An entity may change the contractual terms of a hedging instrument, hedged item or forecasted transaction without dedesignating the hedge relationship (848-30-25-5).
- Changes to the contractual terms of a derivative designated as a hedging instrument may be made in the following ways (848-30-25-6):
  - Through direct contract amendments
  - By entering into a fully offsetting derivative contract to effectively cancel the original derivative and contemporaneously entering into a new derivative with revised contractual terms
- A change to the interest rate used for discounting, margining or contract price alignment of a derivative contract is not considered a change in the critical terms of the hedging relationship requiring dedesignation (848-30-25-7).

Recognizing components excluded from the assessment of hedge effectiveness

- If changes are made to the contractual terms of a hedging instrument, the entity may change the systematic and rational method used to recognize any excluded components into earnings (848-30-25-12).
  - The amended systematic and rational method is applied prospectively for the remaining life of hedging relationship (848-30-25-12).
  - The amended systematic and rational method may be changed if subsequent changes are made to the contractual terms of the hedging instrument (848-30-25-12).
- If the changes made to the contractual terms of a hedging instrument cause a change in the fair value of the excluded components, an entity may elect to recognize this change in fair value in current earnings (848-30-25-13).

Scope: Guidance applies to hedging relationships in which:

- The hedging instrument, hedged item or forecasted transaction references a rate in the scope of ASC 848-10-15-3 (i.e., LIBOR or another rate that is expected to be discontinued due to reference rate reform)
- The hedging derivative is in the scope of ASC 848-10-15-3A (i.e., it does not reference a rate expected to be discontinued due to reference rate reform but is affected by the discounting transition)

Changes to the critical terms on existing hedges

For an entity to be eligible to elect this expedient, changes made to the hedging instrument, hedged item or forecasted transaction must be related to the replacement of a rate due to reference rate reform as described in the section on eligibility of modified contracts. When modifying a derivative that is designated as a hedging instrument, an entity can either directly amend the derivative or enter into an offsetting derivative contract to effectively cancel the original derivative and contemporaneously enter into a new derivative with revised contractual terms.

In addition, the guidance indicates that a change to the interest rate used for discounting, margining or contract price alignment of a derivative contract is not considered a change in the critical terms of the hedging relationship requiring dedesignation.

Recognizing components excluded from the assessment of hedge effectiveness

ASC 815 permits entities to exclude a portion of the change in fair value of a hedging derivative (e.g., the cross-currency basis spread in a cross-currency swap) from the assessment of hedge effectiveness. An entity would recognize amounts excluded from the assessment of hedge effectiveness in earnings through a systematic and rational method, unless it makes an accounting policy election to immediately recognize changes in the fair value of any excluded components in earnings. See sections 4.8.3.5, 5.2.1, and 6.3.1 of our Financial reporting developments (FRD) publication, ***Derivatives and Hedging***, for additional guidance.

If a hedging instrument is modified due to reference rate reform, entities can use an optional expedient to change the systematic and rational method used to recognize any excluded components into earnings. The revised method would be applied prospectively for the remaining life of the hedging relationship. However, the revised systematic and rational method may be changed again if subsequent changes are made to the contractual terms of the hedging instrument due to reference rate reform.

Additionally, if the changes made to the contractual terms of a hedging instrument cause the fair value of the excluded components to change, an entity may elect to recognize this change in fair value immediately in earnings.

Optional expedients that can be applied to fair value and cash flow hedges

While many of the optional expedients in ASC 848 are tailored to address the issues related to either fair value hedges or cash flow hedges, certain expedients are applicable to either type of hedging relationship.

The optional expedients that may be applied to in-scope fair value and cash flow hedging relationships are summarized below.

Optional expedients for fair value and cash flow hedging relationships

Changes to the designated hedging instrument

- An entity may combine two or more derivative instruments (or proportions of those instruments) to be jointly designated as the hedging instrument without dedesignating the hedging relationship (848-30-25-9(b)).
- An entity may subsequently remove one or more derivative instruments (or proportions of those of those instruments) previously added as the designated hedging instrument without dedesignating the hedging relationship (848-30-25-9(b).

Fair value hedge

- If an entity that uses a quantitative method to subsequently assess hedge effectiveness chooses to change the hedging instrument to jointly designate a combination of two or more derivative instruments (or proportions of those instruments), it may select a new method provided in ASC 815 to assess hedge effectiveness (848-30-25-10).
- If an entity that applies the shortcut method to assess hedge effectiveness chooses to change the hedging instrument to jointly designate a combination of two or more derivative instruments (or proportions of those instruments), it may continue to apply the shortcut method using the expedient in ASC 848-40-25-8 or select a new method provided in ASC 815 to assess hedge effectiveness (848-30-25-10).
  - If the entity elects to continue to use the shortcut method, it may disregard any condition in the shortcut requirements that prohibits more than one derivative from being designated as a hedging instrument.
  - An entity is not permitted to continue using the expedient in ASC 848-40-25-8 to apply the shortcut method to a hedging relationship where two or more derivative instruments (or proportions of those instruments) are jointly designated as the hedging instrument after 31 December 2024.

Cash flow hedge

- If an entity chooses to change the hedging instrument to jointly designate a combination of two or more derivative instruments (or proportions of those instruments), it can subsequently assess the effectiveness of the amended hedging relationship using (1) a method provided in ASC 815 or (2) one of the following methods provided in ASC 848 (848-30-25-11):
  - A method that assumes perfect effectiveness based on the optional expedients in 848-50-35-4 through 35-9
  - A qualitative method based on the optional expedients in 848-50-35-10 through 35-16
  - A quantitative method based on the optional expedients in 848-50-35-17 through 35-18
- An entity that applies a subsequent method that assumes perfect hedge effectiveness based on the expedients in ASC 848 may disregard any condition in ASC 815 that prohibits more than one derivative from being designated as a hedging instrument (848-30-25-11).

Scope: The guidance applies only to hedging relationships where the hedging instrument, forecasted transaction or designated benchmark interest rate (in a fair value hedge) references LIBOR or another rate that is expected to be discontinued due to reference rate reform.

To manage the transition to new reference interest rates, some entities may choose to enter into a basis swap (e.g., a LIBOR-SOFR basis swap) as a way to change the reference rate index of the hedging instrument before the discontinuation of LIBOR or other eligible reference rates. In this case, an entity may want to add the basis swap to an existing hedge relationship.

The FASB provided an optional expedient in ASC 848-30-25-9(b) that allows an entity to change the designated hedging instrument in an existing fair value or cash flow hedging relationship by combining two or more derivative instruments (or proportions of those instruments) and jointly designating them as the hedging instrument without dedesignating the hedge.

In addition, the entity may subsequently remove one or more derivative instruments (or proportions of those instruments) previously added as the designated hedging instrument without dedesignating the hedging relationship.

As noted in the graphic above, these expedients can only be applied to hedging relationships in which the hedging instrument, forecasted transaction or designated benchmark interest rate (in a fair value hedge) reference LIBOR or another rate that is expected to be discontinued due to reference rate reform.

While the expedient to add one or more derivatives to an existing hedging instrument applies to both fair value and cash flow hedges, the guidance on how such a change can affect the subsequent assessment of hedge effectiveness differs by the type of hedge.

Fair value hedges

If an entity using a quantitative method to assess hedge effectiveness elects to apply this expedient to a fair value hedge, it can choose to change its assessment method. However, the method chosen must be applied in accordance with the existing requirements in ASC 815-20 and ASC 815-25.

If an entity is applying the shortcut method to assess hedge effectiveness at the time it chooses to change the hedging instrument to jointly designate a combination of two or more derivative instruments (or proportions of those instruments), it can elect to continue applying this method using the optional expedient in ASC 848-40-25-8. This expedient allows entities to disregard certain requirements in ASC 815-20-25-104 when determining whether the hedging relationship continues to qualify for the shortcut method. (Refer to the section on optional expedients for fair value hedges for additional discussion of the relief provided in ASC 848-40-25-8.)

Alternatively, the entity can choose to change its assessment method from the shortcut method to a method applied in accordance with the existing requirements in ASC 815-20 and ASC 815-25.

If the entity elects to continue to use the shortcut method by applying the optional expedient in ASC 848-40-25-8, it may disregard any condition in the shortcut requirements that prohibit more than one derivative from being designated as a hedging instrument. However, an entity is not permitted to continue to use the expedient in ASC 848-40-25-8 to apply the shortcut method to a hedging relationship where two or more derivative instruments (or proportions of those instruments) are jointly designated as the hedging instrument after 31 December 2024.

How we see it

The limitation on applying the optional expedient in ASC 848-40-25-8 after the sunset date in ASC 848 does not apply to all fair value hedging relationships affected by reference rate reform where an entity elects to continue applying the shortcut method.

This limitation only applies to relationships where the entity has elected to add one or more derivatives to the original hedging instrument as discussed above. Therefore, an entity that applies the optional expedients in ASC 848-40-25-8 when the reference interest rate on the hedging swap is changed from LIBOR to SOFR may disregard certain requirements in ASC 815-20-25-104 for the remaining life of the hedging relationship, including for periods after the sunset date, when determining whether the shortcut method can continue to be applied.

Cash flow hedges

An entity that applies the optional expedient to add one or more derivatives to an existing hedging instrument in a cash flow hedge may change the method used to assess hedge effectiveness. However, in this case, the entity is never required to choose a method that must be applied in accordance with ASC 815. Instead, the entity may choose to apply one of the optional expedient methods provided in ASC 848-50-35 for subsequently assessing hedge effectiveness. These methods are discussed in detail in the section on optional expedients applicable to cash flow hedges.

Optional expedients that can be applied to fair value hedges

ASC 848 provides a number of optional expedients for fair value hedges affected by reference rate reform that address rebalancing a hedge relationship, the continued application of the shortcut method and the ability to change the designated benchmark interest rate being hedged. These expedients are discussed below.

Rebalancing

ASC 848-30-25-9(a) provides an optional expedient that allows entities to change the proportion of the hedged item or hedging instrument in an existing fair value hedge without dedesignating the hedging relationship as summarized below.

Optional expedients for rebalancing fair value hedges

- An entity may rebalance a hedging relationship by changing the proportion of a hedged item or hedging instrument without dedesignating the hedge through any of the following approaches (848-30-25-9(a)):
  - Increase/decrease the designated notional amount of the hedging instrument
  - Increase/decrease the designated portion of the hedged item
- If an entity applies the second approach, the cumulative effect of changing the designated proportion of the hedged item is recognized as a change to the fair value hedge basis adjustment. This change in the basis adjustment of the hedged item should be recognized in current earnings (848-30-25-9(a)).

Scope: The guidance applies only to hedging relationships where the hedging instrument or designated benchmark interest rate references LIBOR or another rate that is expected to be discontinued due to reference rate reform.

This expedient can be applied to fair value hedges affected by reference rate reform when the entity has designated LIBOR or another reference rate expected to be discontinued as the designated benchmark interest rate being hedged or when the hedging instrument references such a rate.

The Board provided this relief in response to stakeholder feedback that the transition to a different benchmark interest rate might require entities to rebalance the hedge ratio in duration-weighted fair value hedges. Based on the guidance in ASC 848, entities may accomplish this by applying any combination of the following:

- Increasing or decreasing the designated notional amount of the hedging instrument
- Increasing or decreasing the designated portion of the hedged item

If an entity chooses to change the designated portion of the hedged item, the cumulative effect of this change on the fair value hedge basis adjustment should be recognized in current earnings in the same income statement line item as the earnings effect of the hedged item.

Other expedients that can be applied to fair value hedges

ASC 848 provides various optional expedients that allow entities to continue to apply the shortcut method to fair value hedging relationships affected by reference rate reform. It also allows entities to change the designated benchmark interest rate in a fair value hedge. These expedients are summarized below.

Optional expedients for fair value hedges

Shortcut method

- An entity may disregard the following conditions for determining whether the hedging relationship continues to qualify for the shortcut method (848-40-25-8):
  - The formula for computing net settlements under the interest rate swap is the same for each net settlement in accordance with ASC 815-20-25-104(d).
  - The terms of the interest rate swap and the hedged item are typical of those instruments, and the terms do not invalidate the assumption of perfect effectiveness in accordance with ASC 815-20-25-104(g).
- An entity is not required to periodically evaluate the above conditions for the remaining life of the hedging relationship, including periods after 31 December 2024 (848-40-25-8).
- An entity may adjust the fair value hedge basis adjustment of the hedged item for the amount of cash compensation (or equivalent) exchanged as a result of the change in the interest rate used for discounting, margining or contract price alignment using a reasonable approach (848-30-25-11B).
  - The entity should use a similar method for similar hedges or justify the use of a different method (848-25-30-11B).
  - The entity may continue to use the shortcut method to assess hedge effectiveness in accordance with the expedient in ASC 848-40-25-8 or select a new method provided in ASC 815 (848-30-25-11B).

Change in designated benchmark interest rate

- An entity may change the designated benchmark interest rate (BMIR) and the component of cash flows being hedged without dedesignating the hedging relationship as follows:
  - For hedging relationships where the hedging instrument meets the scope of ASC 848-10-15-3, when (1) the referenced interest rate index of the hedging instrument is changed or (2) the designated hedging instrument is changed to jointly designate a combination of two or more derivative instruments (848-40-25-2)
  - For hedging relationships where the hedging instrument is in the scope of ASC 848-10-15-3A, when the interest rate used for discounting, margining or contract price alignment is modified (848-40-25-2)
- If an entity chooses to change the designated BMIR, it needs to revise the rate used to discount the cash flows of the hedged item and may also choose to adjust the cash flows of the hedged item (848-40-25-4).
- When the designated BMIR is changed, an entity may apply an approach that (1) adjusts the cumulative fair value hedge basis adjustment of the hedged item for the change in the designated BMIR or (2) does not result in an adjustment to the cumulative fair value hedge basis adjustment (e.g., by applying a spread to the revised discount rate) (848-40-25-5).
  - If an entity applies approach (1), it should recognize the change in the fair value hedge basis adjustment of the hedged item in current earnings (848-40-25-7).
- The revised BMIR should be used in calculating subsequent changes in the hedged item's fair value attributable to changes in the BMIR (848-40-25-6).

Scope: The guidance applies to hedging relationships in which:

- The hedging instrument references LIBOR or another rate that is expected to be discontinued due to reference rate reform
- The hedging derivative does not reference a rate expected to be discontinued due to reference rate reform but is affected by the discounting transition

Application of the shortcut method

As previously discussed, ASC 848-30-25-10 provides an expedient that allows for the continued application of the shortcut method when an entity chooses to change the designated hedging instrument by combining two or more derivative instruments and jointly designating them as the hedging instrument in an existing fair value hedge.

The Board also provided relief for modifications of hedging instruments as a result of reference rate reform based on its belief that entities applying the shortcut method to fair value hedges of interest rate risk should not be penalized when they are compelled to change the terms of a derivative because of reference rate reform.

To allow for the continued application of the shortcut method when a hedging instrument is modified to directly replace a reference rate that is expected to be discontinued, ASC 848-40-25-8 allows entities to choose to disregard the following requirements for determining whether a fair value hedging relationship continues to qualify for the shortcut method:

- The formula for computing net settlement under the interest rate swap is the same for each net settlement in accordance with ASC 815-20-25-104(d).
- The terms of the interest rate swap and the hedged item are typical of those instruments and do not invalidate the assumption of perfect effectiveness in accordance with ASC 815-20-25-104(g).

Entities can change the designated benchmark rate in a fair value hedge if certain criteria are met.

In addition, the Board provided guidance on how to address the difference between the hedging instrument's fair value and the hedged item's basis adjustment that can occur in a fair value hedging relationship for which the shortcut method is applied, due to the cash compensation paid or received as part of the discounting transition. ASC 848-30-25-11B allows an entity to adjust the fair value hedge basis adjustment of the hedged item for the amount of cash compensation (or equivalent) using a reasonable approach.

For example, an entity could choose to adjust the basis of the hedged item for the amount of cash compensation paid or received and immediately recognize this amount in earnings. While no specific approach is specified, the guidance states that an entity should use a similar approach for similar hedges or justify why a different approach was used.

In addition, the guidance states that if an entity applies the optional expedient to adjust the fair value hedge basis adjustment of the hedged item, it can either elect the optional expedients in ASC 848-40-25-8 (described above) and continue to apply the shortcut method or select a new method to assess hedge effectiveness applied in accordance with the existing requirements in ASC 815.

Change in the designated benchmark interest rate

ASC 815 allows entities to hedge the change in fair value of a financial asset or financial liability, a recognized loan servicing right or a nonfinancial firm commitment with financial components due to changes in a designated benchmark interest rate. Accordingly, entities can hedge the change in fair value of a US-dollar fixed-rate financial instrument for changes in any of the following eligible US benchmark interest rates: LIBOR Swap Rate, Fed Funds Overnight Index Swap Rate, Securities Industry and Financial Markets Association Municipal Swap Rate, SOFR OIS Rate and the rate on direct treasury obligations of the US government.[8]

When entities calculate the change in the hedged item's fair value attributable to changes in the designated benchmark interest rate, ASC 815 allows them to use either (1) the full contractual coupon cash flows or (2) the benchmark interest rate component (determined at hedge inception) of the contractual coupon cash flows. See section 5.3 of our FRD publication, ***Derivatives and Hedging***, for additional discussion of these approaches.

ASC 848 provides an optional expedient that allows entities to change the designated benchmark interest rate and the component of cash flows used to determine the change in fair value of the hedged item in a fair value hedge of interest rate risk affected by reference rate reform (including the discounting transition) without having to dedesignate the hedging relationship. Although the hedged item itself will not need to be modified due to reference rate reform since it is a fixed-rate instrument, the Board provided this expedient because a change made to the hedging instrument could affect the effectiveness of the hedging relationship.

For example, if a LIBOR-based swap is designated as the hedging instrument in a fair value hedge and an entity selected the LIBOR swap rate as its designated hedged interest rate risk, the change in fair value of the swap and the change in fair value of the hedged item based on a LIBOR swap rate would diverge if the swap's variable rate changes to another rate, such as SOFR. By applying the optional expedient in ASC 848-40-25-2 to change the benchmark interest rate designated as being hedged to SOFR, the entity could realign the hedging relationship without dedesignation.

To apply this optional expedient, all of the following criteria must be met:

- The designated benchmark interest rate being changed is LIBOR or another rate expected to be discontinued (i.e., a rate in the scope of ASC 848-10-15-3) or the rate used for discounting, margining or contract price alignment for derivative instruments in the scope of ASC 848-10-15-3A.
- The replacement designated benchmark interest rate is an eligible benchmark interest rate in accordance with ASC 815-20-25-6A.
- The hedging instrument is expected to be highly effective at prospectively offsetting changes in fair value attributable to the revised hedged risk on the basis of the amended terms of the hedging relationship.

The guidance on when the designated benchmark interest rate and component cash flows can be changed depends on whether the hedging instrument references an eligible reference rate as follows:

- For hedging relationships in which the hedging instrument references an eligible reference rate, an entity can elect to change the benchmark interest rate designated as being hedged when the referenced interest rate index of the hedging instrument is changed or when the designated hedging instrument is changed to jointly designate a combination of two or more derivative instruments.
- For hedging relationships in which the hedging instrument does not reference an eligible reference rate, an entity can elect to change the benchmark interest rate designated as being hedged when the interest rate used for discounting, margining or contract price alignment is modified.

How we see it

Even though the interest rate index referenced on the floating leg of a swap does not change as a result of the discounting transition, the Board decided to allow entities to change the designated benchmark interest rate in a fair value hedge of interest rate risk at the time the hedging derivative is affected by the discounting transition if the derivative does not reference LIBOR or another rate expected to be discontinued due to reference rate reform.

While this allows entities to match the discount rate used for the hedged item with the revised discount rate on the affected derivative (e.g., SOFR), it does not result in the hedge being completely aligned since the interest rate index referenced in the floating leg of the swap remains unchanged (e.g., Fed Funds rate).

In contrast, entities cannot elect to change the designated benchmark interest rate in a fair value hedge at the time of the discounting transition when the hedging instrument references an eligible reference rate (e.g., LIBOR). Instead, the entity must wait until the interest rate index on the floating leg of the swap is changed (either directly or through the addition of a basis swap that is jointly designated) to change the benchmark interest rate designated as being hedged.

In this case, changing the designated benchmark interest rate would serve to reduce the extent of ineffectiveness historically recognized on certain fair value hedges of interest rate risk since a consistent interest rate (e.g., SOFR) will be used for discounting cash flows on the hedged item and for projecting and discounting cash flows on the hedging swap.

If an entity elects to change the designated benchmark interest rate in a fair value hedge affected by reference rate reform, it should update its hedge documentation accordingly. The entity must use the newly designated benchmark rate to discount the cash flows of the hedged item when determining the change in its fair value due to changes in the benchmark interest rate for measurement and assessment purposes. The guidance allows the entity to include a spread adjustment to the revised discount rate and to adjust the component cash flows for the designated term of the hedged item if it chooses.

The entity would continue to use the revised benchmark interest rate (including any spread adjustment to the discount rate) and the revised remaining component cash flows (if applicable) for the duration of the hedging relationship, including periods after the sunset date.

At the time the designated benchmark interest rate is changed, ASC 848 allows an entity to choose to apply either of the following approaches to reflect the effect of the change in the designated benchmark interest rate:

- An approach that adjusts the hedged item's cumulative fair value hedge basis adjustment, which results in the entity recognizing the change in the basis adjustment of the hedged item in earnings immediately, in the same income statement line used to present the earnings effect of the hedged item

- An approach that results in no adjustment to the hedged item's cumulative fair value hedge basis adjustment by, for example, including a spread adjustment in the revised benchmark interest rate used to discount the cash flows of the hedged item (i.e., a denominator approach) or by adjusting the cash flows of the hedged item such that the present value of the adjusted cash flows discounted at the revised benchmark interest rate results in no change to cumulative basis adjustment (i.e., a numerator approach)

While ASC 848 does not prescribe the method an entity should use to account for the change in the designated benchmark rate and the effect of this change on the cumulative fair value hedge basis adjustment to the hedged item, it requires any method used to be reasonable. It also requires similar methods to be applied to similar hedges (or for the use of different methods to be justified).

How we see it

When deciding what method to apply, entities should carefully consider any potential ongoing effects. For example, applying an approach that results in no adjustment to the hedged item's cumulative fair value hedge basis adjustment when the designated benchmark interest rate is changed could result in additional hedge ineffectiveness being recognized over the remaining life of the hedge.

Optional expedients that can be applied to cash flow hedges

In cash flow hedges of interest rate risk, both the hedging instrument and the hedged item or forecasted transaction will often need to be modified due to reference rate reform. As a result, ASC 848 provides numerous optional expedients that entities can elect to apply to ease the application of cash flow hedge accounting during the transition period.

These expedients address various requirements in ASC 815 related to cash flow hedges, including the likelihood that a hedged forecasted transaction is probable of occurring, the ability of an entity to change the designated hedged risk, the criteria to hedge a group of forecasted transactions, the various methods used to assess hedge effectiveness both at inception and on a subsequent basis and the ability to adjust amounts in accumulated other comprehensive income (AOCI) due to the cash compensation resulting from the discounting transition. These expedients are discussed below and summarized in the graphics in each section.

Probability of the hedged forecasted transaction

Optional expedients for cash flow hedges

Probability of forecasted transaction

- An entity may assert that the hedged forecasted transaction remains probable of occurring regardless of the modification or expected modification of terms (848-50-25-2).

Scope: Applies only to cash flow hedging relationships of a forecasted transaction where the designated hedged interest rate risk is LIBOR or another rate that is expected to be discontinued due to reference rate reform.

To qualify for cash flow hedge accounting, an entity must be able to assert that the forecasted transaction being hedged is probable of occurring. Constituents raised concerns about whether an entity could assert that forecasted transactions referencing LIBOR or another reference rate expected to be discontinued as a result of reference rate reform remained probable of occurring when the hedge extended beyond the date that the referenced rate was expected to be discontinued (e.g., when hedging LIBOR-based interest coupons of a variable-rate debt instrument whose maturity extended past the date that LIBOR is no longer expected to be published).

To address this issue, ASC 848-50-25-2 provides an expedient that allows an entity to assert that a hedged forecasted transaction referencing LIBOR or another eligible reference rate remains probable of occurring, regardless of the modification or expected modification to the terms of the hedged item to replace the reference rate.[9]

This expedient does not eliminate the need for an entity to broadly assess whether the underlying hedged forecasted transaction (e.g., future interest receipts or interest payments) remain probable of occurring. As a result, an entity that decides to pay off (and not refinance) its existing variable-rate debt in lieu of modifying the terms of the debt would be required to cease cash flow hedge accounting.

Change in the designated hedged interest rate risk

Optional expedients for cash flow hedges

Change in designated hedged interest rate risk

- In accordance with ASC 815-30-35-37A, an entity may continue to apply hedge accounting to a hedge of a forecasted transaction where the designated hedged risk changes, as long as the hedge remains highly effective.
- When applying this guidance to hedges of an existing variable-rate hedged item or the forecasted issuance or purchase of a variable-rate debt instrument affected by reference rate reform, an entity may continue to apply hedge accounting if the hedge remains highly effective based on an assessment method in ASC 815 or an optional expedient assessment method provided in 848-50-35-1 through 35-18 (848-50-25-3).
- This guidance also applies to hedges of a forecasted issuance or purchase of a fixed-rate debt instrument where the hedging relationship is affected by reference rate reform.
  - If the designated hedged risk is variability in cash flows attributable to changes in a designated BMIR, and the referenced interest rate index of the hedging instrument changes or an entity changes the designated hedging instrument to combine two or more derivatives to be jointly designated as the hedging instrument, an entity may change a designated BMIR within the scope of paragraph 848-10-15-3 to another eligible BMIR, if certain criteria are met (848-50-25-3).

Scope: Applies only to hedging relationships where the hedging instrument, hedged item or forecasted transaction references LIBOR or another rate that is expected to be discontinued due to reference rate reform.

ASC 815-30-35-37A states that an entity may change the designated hedged risk for a cash flow hedge of a forecasted transaction and continue to apply hedge accounting if the hedge remains highly effective. ASC 848 clarifies how this guidance is applied when the hedge risk is changed as a result of reference rate reform.

ASC 848-50-25-3 states that an entity may continue to apply hedge accounting to a cash flow hedge of an existing variable-rate hedged item or a forecasted issuance or purchase of a variable-rate debt instrument affected by reference rate reform as long as the hedging relationship remains highly effective based on an assessment model applied in accordance with ASC 815 or based on an optional expedient method to subsequently assess hedge effectiveness under ASC 848-50-35. (Refer to the section on optional expedients related to subsequent assessment methods for additional discussion.)

The guidance also applies to a cash flow hedge of a forecasted issuance or purchase of a fixed-rate debt instrument when the hedging relationship is affected by reference rate reform. ASC 848-50-25-3 indicates that if the designated hedged risk is the variability in cash flows attributable to changes in the benchmark interest rate in accordance with ASC 815-20-25-19A(a) or 25-19B, and the referenced interest rate index of the hedging instrument changes or an entity changes the designated hedging instrument to combine two or more derivatives to be jointly designated as the hedging instrument, an entity is allowed to change the hedged risk without discontinuing the hedge if (1) the original benchmark interest rate being hedged is LIBOR or another rate expected to be discontinued, (2) the replacement rate is a benchmark interest rate eligible to be hedged in accordance with ASC 815-20-25-6A and (3) the hedging relationship remains highly effective based on an assessment model applied in accordance with ASC 815.

An entity is not able to apply any of the optional expedient methods provided in ASC 848-50-35 when determining whether a cash flow hedge related to a forecasted issuance or purchase of a fixed-rate debt instrument remains highly effective based on the revised hedged risk.

Group of forecasted transactions

Optional expedients for cash flow hedges

Hedging a group of forecasted transactions

- When hedging a group of forecasted transactions affected by reference rate reform, an entity may disregard the guidance in ASC 815-20-25-15(a)(2) requiring that the individual transactions in the group share the same risk exposure for which they are designated as being hedged (848-50-25-14).
- The limitation in ASC 815-20-25-15(a)(2) that a forecasted purchase (including debt issuance) and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction continues to apply (848-50-25-14).

Scope: The guidance applies only to hedging relationships where a transaction in the hedged group of forecasted transactions references LIBOR or another rate that is expected to be discontinued due to reference rate reform.

The Board noted that additional complexities may exist when an entity hedges a group of forecasted transactions in a cash flow hedge affected by reference rate reform (e.g., when an entity is hedging a group of variable-rate loans that reference LIBOR). For instance, meeting the requirement in ASC 815-20-25-15(a)(2) that all transactions in the group share the same risk exposure could be challenging because individual forecasted transactions in a group may transition to a new reference rate at different times. That is, certain of the variable-rate instruments in the group may continue to reference LIBOR, while the reference interest rate for other instruments in the group may have already been changed to SOFR.

To allow entities to continue to hedge groups of forecasted transactions that reference LIBOR or another rate expected to be discontinued, ASC 848 provides an optional expedient that allows an entity to disregard the requirement that a group of individual transactions share the same risk exposure for which they are designated as being hedged. This expedient can be applied until the sunset date as long as a single forecasted transaction in the hedged group references LIBOR or another rate that is expected to be discontinued due to reference rate reform.

However, the prohibition in ASC 815-20-25-15(a)(2) that a forecasted purchase (including debt issuance) and a forecasted sale cannot both be included in the same group of individual transactions being hedged continues to apply. Therefore, an entity cannot include interest receipts and interest payments in the same group of forecasted transactions being hedged.

How we see it

Entities that hedge groups of forecasted transactions affected by reference reform and elect to apply this optional expedient would likely choose to also apply one of the optional expedient methods in ASC 848-50 to assess hedge effectiveness during the transition period. As discussed in more detail below, these methods allow entities to disregard certain differences between the hedging instrument and the hedged item/forecasted transaction in the assessment of hedge effectiveness if there is a timing difference between when the hedging instrument and hedged item are modified as a result of reference rate reform.

Assessing hedge effectiveness

Optional expedients for cash flow hedges

Change in the method used to assess hedge effectiveness

- An entity may the change the method used to assess hedge effectiveness from the method originally documented at hedge inception to one of the optional expedient methods provided in ASC 848-50 without dedesignating the hedge relationship (848-30-25-8).
- Upon the required discontinuance of an optional expedient method in ASC 848-50, an entity may change to an assessment method provided in ASC 815 without having to assess whether the replacement method is an improved method for assessing effectiveness or a preferable method of applying an accounting principle in accordance with ASC 250 (848-30-25-8).

Scope: The guidance applies only to hedging relationships where either the forecasted transaction or the hedging instrument references LIBOR or another rate that is expected to be discontinued due to reference rate reform.

ASC 848 provides an optional expedient that allows an entity to change the method used to assess the effectiveness of a cash flow hedge from the method originally documented at hedge inception to one of the optional expedient methods provided in ASC 848-50, without dedesignating the hedge relationship. As discussed further below, ASC 848 provides various optional expedient methods that can be applied for both the initial and subsequent assessments of hedge effectiveness, performed either qualitatively or quantitively.

However, these optional expedient methods can generally only be applied to assess hedge effectiveness when either the hedging instrument or the hedged forecasted transaction references LIBOR or another rate expected to be discontinued. That is, with limited exceptions (discussed further below), these expedients cannot be applied (1) before either the hedging instrument or hedged forecasted transaction is modified to change the reference rate or (2) after both the hedging instrument and the hedged forecasted transaction have been modified to change the reference rate.

This relief allows an entity to disregard differences between the hedged forecasted transaction and the hedging instrument that result from changing the reference rate and any corresponding modifications that are related to the replacement of the reference rate from its assessment of hedge effectiveness. However, any differences that remain after both the hedged forecasted transaction and the hedging instrument have been modified as a result of reference reform can no longer be ignored in the assessment of hedge effectiveness. That is because these differences will remain for the life of the hedge, which would be inconsistent with the Board's objective to provide temporary relief.

Similarly, the expedient methods to assess the effectiveness of cash flow hedges cannot be applied after the relief period ends (i.e., after the 31 December 2024 sunset date), even if the hedging instrument or the hedged forecasted transaction continues to reference a rate that is expected to be discontinued.

Upon the required discontinuation of an optional expedient method for either of the reasons noted above (or if an entity simply chooses to stop applying the expedient), ASC 848 clarifies that an entity can elect to apply an assessment method in accordance with the requirements in

ASC 815 without having to assess whether the replacement method is an improved method for assessing effectiveness or a preferable method of applying an accounting principle in accordance with ASC 250. That is, an entity is not required to use the same assessment method that was used before its election of an optional expedient method in accordance with ASC 848-50.

Initial assessment of hedge effectiveness

ASC 848 provides relief that allows an entity to make certain modifications to the relevant methods in ASC 815 for performing an initial assessment of hedge effectiveness for new cash flow hedges that will be affected by reference rate reform. The relief can generally be applied when either the hedged forecasted transaction or the hedging instrument references LIBOR or another rate expected to be discontinued.

The guidance provides modifications that can be applied to methods that assume perfect effectiveness, as well as quantitative methods, as summarized below.

Entities can disregard certain conditions that are generally required for the assumption of perfect effectiveness under various assessment methods.

Optional expedients for cash flow hedges

Initial assessment of hedge effectiveness

- Entities may apply certain modifications to the methods used for performing an initial assessment of hedge effectiveness (848-50-25-5).
- Entities can disregard certain conditions generally required for the assumption of perfect effectiveness when initially assessing hedge effectiveness qualitatively under the following methods (848-50-25-5):
  - Shortcut method (848-50-25-6)
  - Terminal value of an option method (848-50-25-7)
  - Simplified hedge accounting approach (848-50-25-8)
  - Change-in-variable-cash-flows method (848-50-25-9)
  - Hypothetical derivative method (848-50-25-10)
- Entities can make certain adjustments when applying the following methods to quantitatively assess effectiveness at hedge inception:
  - Change-in-variable-cash-flows method (848-50-25-11)
  - Hypothetical derivative method (848-50-25-11)
  - Change-in-fair-value method (848-50-25-11)

Scope: The guidance applies only to hedging relationships where either the forecasted transaction or the hedging instrument references LIBOR or another rate that is expected to be discontinued due to reference rate reform. However, the optional expedient in ASC 848-50-25-11(a), which allows an entity to assume that the reference rate will not be replaced for the remainder of the hedging relationship, is generally applied when both the forecasted transaction and the hedging instrument references a rate in the scope of ASC 815-10-15-3.

Assessment methods that assume perfect effectiveness

ASC 815 requires an entity to perform an initial prospective assessment of hedge effectiveness on a quantitative basis unless one of the methods that allows for the assumption of perfect hedge effectiveness listed in ASC 815-20-25-3(b)(2)(iv)(01) applies.

ASC 848 provides optional expedients that allow an entity to disregard certain conditions that are generally required for the assumption of perfect effectiveness under each of the following methods discussed below.

Shortcut method

ASC 848-50-25-6 allows an entity to disregard the following conditions in determining whether it can apply the shortcut method for assuming perfect hedge effectiveness in a cash flow hedge:

- The formula for computing net settlements under the interest rate swap is the same for each net settlement in accordance with ASC 815-20-25-104(d).
- The terms are typical of those derivative instruments and do not invalidate the assumption of perfect effectiveness in accordance with ASC 815-20-25-104(g).
- The repricing dates of the variable-rate asset or variable-rate liability and the hedging instrument must occur on the same dates and be calculated the same way in accordance with ASC 815-20-25-106(d).
- The index on which the variable leg of the interest rate swap is based matches the contractually specified interest rate designated as the interest rate being hedged for that hedging relationship in accordance with ASC 815-20-25-106(g).

Terminal value method for options

ASC 848-50-25-7 allows an entity to disregard the following conditions in determining whether a cash flow hedge may be considered perfectly effective when an option's terminal value is used to assess hedge effectiveness:

- The underlying of the hedging instrument matches the underlying of the hedged forecasted transaction in accordance with ASC 815-20-25-129(a).
- The strike price (or prices) of the hedging option (or combination of options) matches the specified level (or levels) beyond (or within) which the entity's exposure is being hedged in accordance with ASC 815-20-25-129(b).
- The hedging instrument's inflows (or outflows) at its maturity date due to the underlying reference rate and strike price (or prices) of the hedging option (or combination of options) completely offset the change in the hedged transaction's cash flows for the risk being hedged in accordance with ASC 815-20-25-129(c).

If all of the other conditions in ASC 815-20-25-129 are met, the hedging relationship may be considered perfectly effective.

Simplified hedge accounting approach

ASC 848-50-25-8 allows an eligible private company to disregard the following conditions in determining whether a cash flow hedge of a variable-rate borrowing with a receive-variable pay-fixed interest rate swap may be considered perfectly effective using the simplified hedge accounting approach:

- Both the variable rates on the swap and the borrowing are based on the same index and reset period in accordance with ASC 815-20-25-137(a).
- The terms of the swap are typical in accordance with ASC 815-20- 25-137(b).
- The repricing and settlement dates for the swap and the borrowing match in accordance with ASC 815-20-25-137(c).

If all of the other conditions in ASC 815-20-25-137 are met, an eligible private company can apply the simplified hedge accounting approach to the hedging relationship.

Change-in-variable-cash-flows method

ASC 848-50-25-9 allows an entity to disregard the following conditions in determining whether a cash flow hedge may be considered perfectly effective under the change-in-variable-cash-flows method:

- The variable-rate leg of the interest rate swap and the hedged variable cash flows of the asset or liability are based on the same interest rate index in accordance with ASC 815-30-35-22(a).
- The interest rate reset dates applicable to the variable-rate leg of the interest rate swap and to the hedged variable cash flows of the asset or liability are the same in accordance with ASC 815-30-35-22(b).

In addition, an entity may disregard the condition in ASC 815-30-35-22(c) that the hedging relationship does not contain any other basis differences if the basis difference in the relationship is due to differences in a cap or floor between the variable rate leg of the interest rate swap and the variable-rate asset or the variable-rate liability.

If all of the other conditions in ASC 815-30-35-22 are met, the hedging relationship may be considered perfectly effective.

Hypothetical derivative method

When assessing whether the hypothetical derivative method will result in a perfectly effective hedge, ASC 848-50-25-10 allows an entity to disregard the requirement that the hypothetical interest rate swap used to assess effectiveness and the hedged forecasted transaction have:

- The same repricing dates in accordance with ASC 815-30-35-25(b)(2)
- The same index (i.e., the index on which the hypothetical interest rate swap's variable rate is based matches the index on which the asset or liability's variable rate is based) in accordance with ASC 815-30-35-25(b)(3)
- Mirror image caps and floors (including a cap or floor that exists in a variable-rate asset or a variable-rate liability and does not exist in a hedging instrument or vice versa) in accordance with ASC 815-30-35-25(b)(4)

If all the other conditions in ASC 815-30-35-25 are met, the hedging relationship may be considered perfectly effective.

Quantitative assessment methods

The FASB also provided relief that can be applied by entities that use one of the following methods to initially assess the effectiveness of cash flow hedging relationships on a quantitative basis (i.e., based on a dollar-offset test or a statistical analysis such as regression):

- Change-in-variable-cash-flows method
- Hypothetical derivative method
- Change-in-fair-value method
- Terminal value method for options

ASC 848-50-35-11 allows an entity to adjust any of the first three methods above as follows:

- When both the hedged forecasted transaction and the hedged instrument reference LIBOR or another eligible reference rate, an entity may assume that the reference rate will not be replaced for the remainder of the hedging relationship and, therefore, does not need to consider the likelihood of whether or when the reference rate will change. This expedient can also be applied to a cash flow hedge of a forecasted purchase, sale or issuance of a fixed-rate instrument when the designated interest rate risk being hedged is a benchmark interest, even though only the hedging instrument would reference a rate that is expected to be discontinued.
- When either the hedged forecasted transaction or the hedging instrument reference LIBOR or another rate that is expected to be discontinued as a result of reference rate reform, an entity may alter the following terms of the hedged forecasted transaction to match the hedging instrument for assessment purposes, thereby eliminating the effect that differences in these terms would have on the effectiveness of the hedging relationship:
  - The referenced interest rate index
  - The reset period, reset dates, day-count conventions, business-day conventions and repricing calculation (e.g., forward-looking calculation or in-arrears calculation)
  - A spread adjustment for the difference between the existing reference rate and the replacement reference rate
  - A cap or floor (including a cap or floor that exists in a variable-rate asset or a variable-rate liability and does not exist in a hedging instrument or vice versa)

If an entity hedges with an option (or combinations of options) and assesses hedge effectiveness on the basis of the option's terminal, ASC 848-50-25-12 allows the entity to adjust certain terms of the perfectly effective hypothetical hedging instrument so that they match the following terms of the hedging instrument:

- The underlying reference rate
- The strike price (or prices) of the hedging option (or combination of options)
- The hedging instrument's inflows (outflows) at its maturity date due to the underlying reference rate and strike price (or prices) of the hedging option (or combination of options)

Subsequent assessment of hedge effectiveness

As noted earlier, ASC 848 allows an entity to change the method used to assess the effectiveness of a cash flow hedge from the one originally documented at hedge inception to one of the optional expedient methods provided in ASC 848-50, without dedesignating the hedging relationship. As a result, an entity can determine whether a cash flow hedging relationship affected by reference rate reform remains highly effective by using one of the optional expedient assessment methods in ASC 848-50-35 to subsequently assess hedge effectiveness.

An entity may elect to apply one of the optional expedient assessment methods if either the hedged forecasted transaction or the hedging instrument references LIBOR or another rate expected to be discontinued. An entity can also elect to apply certain optional expedient methods if the hedging instrument meets the scope of ASC 848-10-15-3A (i.e., the hedging instrument does not reference LIBOR or another rate expected to be discontinued, but the interest rate used for discounting, margining or contract price alignment is modified).

If an entity elects to change the method used to subsequently assess hedge effectiveness for a cash flow hedge to an optional expedient method, it needs to update its hedge documentation in accordance with the requirement in ASC 848-30-25-4.

In addition, if an entity elects to apply an optional expedient method, it would determine whether hedge accounting can continue to be applied by prospectively applying the new method as of the date the expedient method is first applied. If the cash flow hedging relationship continues, the entity would subsequently assess the hedging relationship, both prospectively and retrospectively, using the optional expedient method from the date on which the expedient method was first applied.

How we see it

When an entity changes the method used to subsequently assess the effectiveness of a cash flow hedge, it does not consider the effect of this change on the hedging relationship before the date the new method is applied. That is, the entity does not subsequently assess hedge effectiveness assuming this change was made at the inception of the hedge.

The FASB included the guidance in ASC 848-50-35-2 to clarify how this would work because this issue generally doesn't arise under existing GAAP, given the requirement in ASC 815-20-55-56 to dedesignate and redesignate a hedging relationship when the method used to assess hedge effectiveness changes.

Subsequent assessment methods that assume perfect effectiveness

Optional expedients for cash flow hedges

Subsequent assessment of hedge effectiveness using a method that assumes perfect effectiveness

- Entities may disregard certain conditions generally required for the assumption of perfect effectiveness when subsequently assessing hedge effectiveness under the following methods (848-50-35-4):
  - Shortcut method (848-50-35-5)
  - Terminal value of an option method (848-50-35-6)
  - Simplified hedge accounting approach (848-50-35-7)
  - Change-in-variable-cash-flows method (848-50-35-8)
  - Hypothetical derivative method (848-50-35-9)
- Entities applying a subsequent hedge assessment method that assumes perfect effectiveness at the time of the discounting transition may apply the above expedients to hedging relationships where the hedging instrument is in the scope of ASC 848-10-15-3A (848-30-25-11A).

Scope: The guidance applies to hedging relationships where:

- Either the forecasted transaction or the hedging instrument LIBOR or another rate that is expected to be discontinued due to reference rate reform
- The hedging derivative does not reference a rate expected to be discontinued due to reference rate reform but is affected by the discounting transition

ASC 848 provides optional expedients that can be used by entities to subsequently assess hedge effectiveness using a method that assumes perfect effectiveness. This relief is consistent with the optional expedients the guidance provides for entities that use such a method to perform their initial assessment of hedge effectiveness.

That is, an entity can continue to disregard certain conditions generally required for the assumption of perfect effectiveness (as described above in the section on the initial assessment of hedge effectiveness) when performing its ongoing assessment of hedge effectiveness using the following methods that assume perfect effectiveness:

- Shortcut method
- Terminal value method for options
- Simplified hedge accounting approach
- Change-in-variable-cash-flows method
- Hypothetical derivative method

If all of the other required conditions specified for each of the above methods are met, an entity can continue to consider the hedging relationship perfectly effective.

The expedients related to the subsequent assessment using these methods can be applied by entities that had been applying a method that assumes perfect effectiveness to hedging relationships in which either the forecasted transaction or the hedging instrument references LIBOR or another rate that is expected to be discontinued due to reference rate reform, as well as to relationships in which the hedging instrument does not reference such a rate but is affected by the discounting transition.

The Board provided this clarification in ASU 2021-01 so that entities that had been applying an assessment method that assumes perfect effectiveness when the interest rate used for discounting, margining or contract price alignment was changed could continue to apply this method to cash flow hedging relationships after the discounting transition. The Board concluded that the mismatch in a cash flow hedge that can result from the cash compensation adjustment made to compensate entities for the change in the fair value of the derivative due to the change in the discounting rate should not require the entity to change its method for assessing hedge effectiveness.

Subsequent assessment methods that do not assume perfect effectiveness

If an entity uses an assessment method that does not assume perfect effectiveness, ASC 848 provides certain optional expedients that may be applied for subsequent assessments performed on a qualitative or quantitative basis, as summarized below.

Optional expedients for the subsequent measurement of cash flow hedges

Qualitative methods

- An entity may disregard the requirements in ASC 815-20-35-2A through 35-2F when subsequently assessing hedge effectiveness on a qualitative basis (848-50-35-10).
- The entity may continue to assess hedge effectiveness on a qualitative basis if the following criteria are met (848-50-35-11):
  - There have been no changes to the terms of the hedging instrument or the forecasted transaction other than those due to reference rate reform.
  - The entity considers whether the counterparty to the hedging derivative is likely to comply with the contractual terms that require it to make payments to the entity. (ASC 815 requires an entity to conclude that it is probable the counterparty will not default to continue applying hedge accounting.)
- If an entity can no longer assert qualitatively that hedge accounting should continue, it would assess hedge effectiveness on a quantitative basis in accordance with ASC 815 or by using a quantitative optional expedient method in accordance with ASC 848-50-35, if eligible (848-50-35-13).

Quantitative methods

- Entities can make certain adjustments when applying the following methods to subsequently assess hedge effectiveness on a quantitative basis:
  - Change-in-variable-cash-flows method (848-50-35-17)
  - Hypothetical derivative method (848-50-35-17)
  - Change-in-fair-value method (848-50-35-17)
  - Terminal value of an option method (848-50-35-18)

Scope: The guidance applies only to hedging relationships where either the forecasted transaction or the hedging instrument references LIBOR or another rate that is expected to be discontinued due to reference rate reform. However, the optional expedient in ASC 848-50-35-17(a), which allows an entity to assume that the reference rate will not be replaced for the remainder of the hedging relationship, is generally applied when both the forecasted transaction and the hedging instrument reference a rate in the scope of ASC 815-10-15-3.

Qualitative assessment methods

ASC 848 provides an optional expedient that allows an entity to qualitatively assess the effectiveness of cash flow hedges on an ongoing basis after the entity has performed its initial assessment of hedge effectiveness using a method applied in accordance with ASC 815 or one of the expedients for initially assessing hedge effectiveness provided in ASC 848-50-25-6 through 25-12.

If an entity applies this expedient, it may disregard the guidance in ASC 815-20-35-2A through ASC 815-20-35-2F when determining whether a cash flow hedging relationship is highly effective on a qualitative basis. Instead, an entity may continue to assert qualitatively that hedge accounting can continue if the following criteria are met:

- The hedged forecasted transaction or the hedging instrument references LIBOR or another rate that is expected to be discontinued as a result of reference rate reform.
- There have been no changes to the terms of the hedging instrument or the forecasted transaction other than those allowed under the scope of the contract modification relief described earlier.
- The entity considers the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the reporting entity. (ASC 815 requires an entity to conclude that it is probable the counterparty will not default to continue to applying hedge accounting.)

An entity is required to verify and document that the facts and circumstances related to the above criteria have not changed whenever financial statements or earnings are reported and at least quarterly.

If the facts and circumstances change and the criteria are no longer met, the entity can no longer assert qualitatively that the hedging relationship qualifies for hedge accounting. In this case, the entity would need to perform a quantitative assessment of hedge effectiveness using a method applied in accordance with ASC 815 or an eligible quantitative optional expedient method provided in ASC 848-50-35-17 through 35-18 (discussed further in the next section). That is, the entity is allowed to change the quantitative method used to subsequently assess hedge effectiveness from the method originally documented at the inception of the hedge without dedesignating the hedging relationship, but it would need to update its hedge documentation to reflect this change in accordance with the guidance in ASC 848-30-25-4.

If the entity cannot identify the date when the change in facts and circumstances that resulted in the criteria no longer being met occurred, it may begin performing quantitative effectiveness assessments as of the beginning of the current period. After performing a quantitative assessment for one or more reporting periods, the entity can revert to a qualitative effectiveness assessment if the criteria are again met.

Quantitative assessment methods

ASC 848 provides the same relief for quantitative methods used to subsequently assess hedge effectiveness (i.e., based on a dollar-offset test or a statistical analysis, such as regression) as it does for quantitative methods used to initially assess hedge effectiveness.

That is, entities may adjust the following methods as described above in the section on the initial assessment of hedge effectiveness on a quantitative basis, when they are used in the ongoing assessment of hedge effectiveness on a qualitative basis:

- Change-in-variable-cash-flows method
- Hypothetical derivative method
- Change-in-fair-value method
- Terminal value method for options

Adjustment to accumulated other comprehensive income

An entity may adjust the amount recorded in accumulated other comprehensive income to address the mismatch that may result from cash compensation paid or received as a result of the discounting transition, as summarized below.

Optional expedients for cash flow hedges

Adjustment to AOCI due to cash compensation resulting from the discounting transition

- An entity may use a reasonable method to adjust the amount recorded in AOCI for the amount of cash compensation paid/received as a result of the discounting transition (848-30-25-11C).
  - The entity should use a similar method for similar hedges or justify the use of a different method (848-25-30-11C).
- Entities that adjust the amount in AOCI for this cash compensation should subsequently assess hedge effectiveness using the applicable expedients provided in ASC 848-30-25-11A (for hedging instruments in the scope of ASC 815-10-15-3A) and 848-30-25-11 (for hedging instruments in the scope of ASC 815-10-15-3) (848-30-25-11C).

Scope: The guidance applies to hedging relationships in which:

- The hedging instrument references LIBOR or another rate that is expected to be discontinued due to reference rate reform
- The hedging derivative does not reference a rate expected to be discontinued due to reference rate reform but is affected by the discounting transition

As part of the discounting transition, central clearing parties (CCPs) provided cash compensation adjustments to compensate entities for the changes in a derivative's fair value and risk profile. If the affected derivative is designated as a hedging instrument in a cash flow hedge, a difference may arise between the amount deferred in accumulated other comprehensive income and the cumulative change in fair value of the derivative (excluding variation margin payments). This is because the change in the fair value of the derivative due to the cash compensation adjustment is not recorded in AOCI.

ASC 848-30-25-11C allows entities to use a reasonable method to adjust the balance in AOCI to address this mismatch. We believe an entity can recognize the difference immediately in earnings or amortize this amount into earnings on a straight-line basis over the remaining life of the hedge, for example. However, the guidance indicates that entities should use a similar method for similar hedges or justify why a different approach was used.

This expedient applies to all derivatives affected by the discounting transition that are designated as the hedging instrument in a cash flow hedge, regardless of whether they reference LIBOR or another rate expected to be discontinued due to reference rate reform.

How we see it

The flexibility provided by the FASB was intended to alleviate concerns raised by stakeholders that the difference between the revised fair value of a hedging derivative affected by the discounting transition and the amount recorded in AOCI could make the accounting for cash flow hedges more complex.

In addition, ASC 848-30-25-11C clarifies how an entity would subsequently assess hedge effectiveness when such an adjustment is made as follows:

- If the hedging instrument is in the scope of ASC 848-10-15-3A, the guidance indicates that an entity that was applying a subsequent quantitative or qualitative assessment method before the discounting transition should continue to use the same method. Entities that previously applied an assessment method that assumes perfect effectiveness can continue to do so or can elect to use an assessment method applied in accordance with ASC 815.
- If the hedging instrument references LIBOR or another rate expected to be discontinued, an entity can subsequently assess hedge effectiveness using a method applied in accordance with ASC 815 or one of the methods applied using the optional expedients provided in ASC 848-50-35.

Discontinuance of the optional expedients related to the assessment of effectiveness for cash flow hedges

An entity is required to discontinue the use of the optional expedients for assessing cash flow hedge effectiveness when any of the following events occur:

- Neither the hedged item nor the hedging instrument that previously referenced LIBOR or another rate expected to be discontinued due to reference rate reform still references that rate. Note that this generally would not apply to hedging relationships affected by the discounting transition if the hedging instrument never referenced an eligible rate.
- The guidance in ASC 848 is superseded, which will occur on the sunset date (i.e., 31 December 2024).
- An entity elects to cease applying the optional expedients.

If a cash flow hedging relationship continues after an entity is required to discontinue the use of an optional expedient method to assess hedge effectiveness, the entity would use an assessment method allowed by ASC 815 to determine whether it may continue to apply hedge accounting. The entity is not required to use the same assessment method it used before it elected the optional expedient method in ASC 848-50, but it should update its hedging documentation to reflect the change in the method. This change in method would not require a dedesignation of the hedging relationship.

ASC 848-50-35-21 clarifies that, when an entity reverts to assessing hedge effectiveness using a method allowed by ASC 815, the entity may create the terms of the instrument used to estimate changes in the fair value of its hedged risk (e.g., the terms of the hypothetical derivative) based on market data as of the inception of the hedging relationship. However, any previous assessments of effectiveness that were performed using an optional expedient assessment method would not be revised.

How we see it

Questions have been raised by stakeholders about how an entity that is reverting back to measuring hedge effectiveness using the hypothetical derivative method in ASC 815 should determine the terms of the hypothetical derivative.

They pointed out that the approach described in ASC 848-50-35-21, which says the terms of the hypothetical derivative may be determined based on market data as of the inception of the hedging relationship, would create a mismatch between the terms of the actual derivative and the hypothetical derivative. This is because the fixed rate on the hypothetical derivative would be determined based on market data related to the revised reference rate (e.g., the SOFR OIS rate) as of the inception of the hedging relationship, whereas the amended fixed rate of the actual derivative would be based on market data in effect at the time the derivative was modified or determined using credit spread adjustment information published by ISDA. Such a mismatch would cause certain hedge relationships to no longer be considered perfectly effective, even though this had been the entity's assumption prior to applying the relief in ASC 848.

In response to a technical inquiry, the FASB staff said the guidance in ASC 848-50-35-21 was not meant to be prescriptive and there could be other acceptable approaches for determining the terms of the hypothetical derivative. One approach we believe would be acceptable is for an entity to determine the fixed rate in the hypothetical derivative using the same spread that was used to adjust the fixed rate on the actual swap when the floating leg of this swap was converted to SOFR from LIBOR.

If all the other terms of the actual and hypothetical derivative match, we believe this alternative would allow entities to continue to assume perfect effectiveness for the hedge relationship.

If a hedging relationship that was previously assessed under an optional expedient does not qualify for hedge accounting under an assessment method allowed by ASC 815, the entity is required to discontinue hedge accounting prospectively and apply the guidance in ASC 815-30-40-2 through 40-6A.

Optional expedients for net investment hedges

ASC 848 provides an optional expedient that allows a receive-variable-rate, pay-variable-rate cross-currency interest rate swap to remain an eligible hedging instrument in a net investment hedge if the repricing terms of the variable legs of the swap no longer align because of reference rate reform, as summarized below.

Optional expedients on changes to repricing intervals and dates in net investment hedges

- An entity may disregard the condition in ASC 815-20-25-67(a)(2) that both legs of a cross-currency swap have the same repricing intervals and dates to be eligible as the hedging instrument in a net investment hedge (848-30-25-7A).

Scope: Applies only to hedging relationships where the hedging instrument is a receive-variable-rate, pay variable-rate cross-currency interest rate swap that references LIBOR or another rate that is expected to be discontinued due to reference rate reform. The expedient can be applied until neither of the variable legs of the cross-currency swap reference LIBOR or another eligible reference rate.

If a receive-variable-rate, pay-variable-rate cross-currency interest rate swap that references LIBOR or another rate expected to be discontinued is used as the hedging instrument in a net investment, an entity is not required to dedesignate the hedging relationship if the index of one leg of the swap changes as a result of reference rate reform. In addition, in this situation, ASC 848-30-25-7A allows an entity to disregard the condition in paragraph 815-20-25-67(a)(2) that requires both legs of the swap have the same repricing intervals and dates in order for the cross-currency interest rate swap to be eligible to be designated as the hedging instrument in a net investment hedge.

This expedient can be applied until neither of the variable legs of the cross-currency interest rate swap references LIBOR or another rate expected to be discontinued due to reference rate reform or the guidance is superseded, which will occur at the sunset date (i.e., 31 December 2024).

Reclassification or sale of held-to-maturity debt securities

ASC 848 permits an entity to make a one-time election to sell and/or reclassify HTM debt securities that reference LIBOR or another eligible reference rate without calling into question the entity's previous classification. This one-time election can be applied to eligible debt securities that were classified as held to maturity before 1 January 2020 and can be made by an entity any time before 1 January 2025.

The guidance clarifies that the sale or reclassification of HTM debt securities under this expedient, in and of itself, would not call into question the entity's assertions at prior reporting dates that it had the intent and ability to hold these debt securities to maturity. It also would not affect the entity's assertion related to debt securities that continue to be classified as held to maturity.

An entity that applies this expedient would recognize the reclassification of HTM debt securities as available for sale or trading as of the date in the reporting period in which the entity makes its one-time election. Upon making the election, the entity would apply the measurement guidance for transfers of debt securities between categories in ASC 320-10-35-10 through 35-16.

The guidance permits entities to make a one-time election to sell and/or reclassify held-to-maturity debt securities that reference an eligible reference rate.

How we see it

An entity can apply this expedient at the individual security level. That is, an entity that elects to apply this expedient is not required to transfer all of its eligible HTM debt securities to available for sale or trading.

However, entities should carefully consider when to make this one-time election and which HTM securities to include. That's because the one-time election must be made at the same time for all HTM debt securities an entity wishes to sell and/or reclassify, and the election is not reversable.

Disclosures

Entities are required to disclose the nature of the optional expedients and exceptions they elect to apply and their reasons for doing so. These disclosures are required in each interim (if applicable) and annual financial statement period in the fiscal year the entity applies the guidance.

Additional considerations

While the guidance in ASC 848 should help to mitigate the cost and complexity of accounting for modified contracts and the potential for earnings volatility, companies still need to focus on operational, legal, information technology and risk management issues related to the transition. For example, companies should have controls in place over the key aspects of their transition process, including:

- Identification of a complete set of contracts that refer to LIBOR and other IBORS expected to be discontinued as a result of reference rate reform
- Identification of contracts (including those in hedging relationships) that meet the criteria defined in the guidance for applying the optional expedients and exceptions

- Identification of contract modifications outside the scope of the guidance that must continue be accounted for in accordance with other applicable standards
- Operation of information systems used to perform calculations affected by reference rate reform and any changes to those systems to make sure they function as intended

Companies should document their election of the optional expedients applied and the evaluation performed to determine the criteria required to apply these expedients have been met.

They also need to consider disclosures about their transition processes. The SEC staff has said it expects registrants to make disclosures about how they are preparing for the phaseout of LIBOR and any anticipated effects that would be material.

Effective dates and transition

The guidance the FASB created with ASU 2020-04 and the amendments provided in ASU 2021-01 have different effective dates and transition requirements, as discussed below.

Guidance issued in March 2020

The guidance in ASU 2020-04 was effective upon issuance for all entities.

The guidance on contract modifications is applied prospectively to modifications made from any date beginning on the 12 March 2020 issuance date.

The guidance on hedge accounting is applied to eligible hedging relationships existing as of the beginning of the interim period that included 12 March 2020 (i.e., 1 January 2020 for a calendar-year company) and to eligible hedging relationships entered into after the beginning of that interim period.

An entity that elects to apply the hedge accounting guidance to an eligible hedging relationship existing as of the beginning of the interim period that includes 12 March 2020 would reflect any adjustments that result from the elections as of the beginning of that interim period and recognize them in accordance with the guidance in ASC 848 that allows for the adjustment. An entity that elects to apply the guidance to a hedging relationship entered into between the beginning of the interim period that includes 12 March 2020 and that date should reflect any adjustments that result from those elections as of the beginning of the hedging relationship and recognize them in accordance with the guidance in ASC 848 that allows for the adjustment.

The hedge accounting guidance is applied prospectively to any eligible hedging relationships entered into after the effective date of the guidance (i.e., 12 March 2020) but before the sunset date (i.e., 31 December 2024).

As noted earlier, the one-time election to sell and/or reclassify debt securities classified as held to maturity may be made by an entity at any time from 12 March 2020 through 31 December 2024.

Amendments issued in January 2021

The amendments in ASU 2021-01 were effective upon issuance for all entities.

Entities may elect to apply the amendments related to contract modifications either (1) retrospectively as of any date from the beginning of any interim period that includes 12 March 2020 or (2) prospectively to new modifications from any date in an interim period that includes or is after 7 January 2021, up to the date that financial statements are available to be issued.

Entities may elect to apply the amendments related to hedge accounting to eligible hedging relationships that existed as of the beginning of an interim period that included 12 March 2020 and to new eligible hedging relationships entered into after the beginning of the interim period that included that date.

If an entity elects to apply the guidance to an eligible hedging relationship, any adjustments as a result of the elections would be reflected as of the application date of the election and recognized in accordance with the applicable guidance in ASC 848 that allows for the adjustment.

Sunset date

The relief provided in ASC 848 is temporary and cannot be applied to contract modifications that occur after 31 December 2024 or hedging relationships entered into after that date. The relief also cannot be applied to hedging relationships evaluated after that date, except for following expedients, which an entity may continue to apply over the remaining life of the hedge, including in periods after 31 December 2024:

- The expedient in ASC 848-30-25-12 related to the systematic and rational method used to recognize in earnings any components excluded from the assessment of effectiveness
- The expedient in ASC 848-40-25-6 related to the revised benchmark interest rate used to discount cash flows associated with the hedged item in a fair value hedge where the designated benchmark interest rate has been changed
- The expedient in ASC 848-30-25-11B to adjust the fair value hedge basis adjustment for the cash compensation adjustment using a reasonable approach in a fair value hedge that is accounted for under the shortcut method and is affected by the discount transition
- The expedient in ASC 848-30-25-11C to adjust the amount recorded in AOCI to address the mismatch stemming from the cash compensation adjustment using a reasonable approach in a cash flow hedge affected by the discounting transition
- The expedient in ASC 848-30-25-11 (for hedging instruments that reference a rate in the scope of ASC 848-10-15-3) and 25-11A(b) (for hedging instruments in the scope of ASC 848-10-15-3A) to continue using a subsequent assessment method that assumes perfect effectiveness for a cash flow hedge where the hedging instrument is affected by the discounting transition and the entity has elected to apply the expedient to adjust the amount recorded in AOCI to address the mismatch stemming from the cash compensation adjustment
- The expedient in ASC 848-40-25-8 not to periodically evaluate certain conditions when using the shortcut method for a fair value hedge unless this expedient is applied to a fair value hedge where the shortcut method continues to be applied after two or more derivative instruments (or proportions of those instruments) are jointly designated as the hedging instrument in accordance with ASC 848-30-25-10

Endnotes:

[1] The guidance codified in ASC 848 was originally issued through ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*.

[2] ASU 2021-01, *Reference Rate Reform (Topic 848): Scope*.

[3] ASU 2022-06, *Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848*.

[4] ASU 2018-16, *Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes*.

[5] Similarly, certain counterparties to bilateral swap agreements have changed the rates used for discounting and determining both the collateral and the interest paid on collateral for non-cleared derivatives.

[6] ISDA issued its IBOR Fallbacks Protocol to enable market participants to incorporate revisions to fallback terms into their legacy derivatives trades with other counterparties that choose to adhere to the protocol.

[7] ASC 848 also provides guidance for modified contracts accounted for under ASC 840, *Leases*.

[8] US GAAP does not provide a similar list of eligible benchmark rates for non-US interest rates. As a result, judgment is needed to determine non-US benchmark interest rates that can be designated as the hedged risk in fair value hedging relationships. Entities should refer to the definition of a benchmark interest rate in the Master Glossary of the Codification when making this determination.

[9] This optional expedient serves to codify a similar view expressed by the SEC Staff at the 2018 American Institute of Certified Public Accountants Conference on Current SEC and PCAOB Developments. The SEC staff indicated that it would not object to an entity continuing to assert that a hedged forecasted transaction referencing LIBOR (or another rate expected to be discontinued) remained probable of occurring based on a conclusion that the hedge documentation implicitly considers a rate that would replace LIBOR.