Optional accounting expedients can make LIBOR transition easier

Prepared by:

Michael Gaiso, Senior Director, National Professional Standards Group, RSM US LLP
michael.gaiso@rsmus.com, +1 212 372 1709

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A. Introduction

The publication of the London Interbank Offered Rate (LIBOR), which was referenced in approximately $350 trillion of contracts, ceased after June 30, 2023. In the U.S., the Secured Overnight Financing Rate (SOFR) has been identified as the preferred alternative to LIBOR as part of reference rate reform. Reference rate reform affects entities that have assets, debt instruments, interest rate swap agreements or other contracts that reference or referenced LIBOR or another rate that has been or is expected to be discontinued.

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting* (the ASU), which provides temporary optional expedients and exceptions to the guidance in U.S. generally accepted accounting principles (GAAP) regarding contract modifications, hedge accounting and other transactions to ease the expected burden on financial reporting related to the upcoming reference rate reform. In December 2022, the FASB issued ASU 2022-06, *Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848,* which extended the temporary optional guidance provided by the ASU to December 31, 2024. This publication, which was originally issued in July 2020, has been updated to reflect the amendments in ASU 2022-06.

B. Key takeaways

- The relief in the ASU may only be applied to contract modifications if the modified contractual terms relate to the replacement of a reference rate due to reference rate reform.
  - If a debt instrument is modified due to reference rate reform to refer to a different reference rate, an entity could elect to account for all such qualifying debt modifications prospectively by adjusting the effective interest rate.
  - If a lease is modified due to reference rate reform, an entity could elect to account for all such qualifying leases as a continuation of the existing contracts with no requirement to reassess previous accounting determinations such as lease classification and the discount rate.
  - Modifying a contract due to reference rate reform does not require reassessment of the original conclusion about whether a derivative embedded in a contract requires separate accounting.
- For hedging relationships affected by reference rate reform, entities may elect various optional expedients that would allow them to continue to apply hedge accounting for hedging relationships, provided certain criteria are met.
- If certain conditions are met, entities may make a one-time election to sell or transfer held-to-maturity (HTM) debt securities that reference an interest rate affected by reference rate reform.
- The ASU became effective when it was issued on March 12, 2020. The guidance in the ASU is optional and generally cannot be applied beyond December 31, 2024.

C. Overview

The cessation of LIBOR is a response to concerns about structural risks to interbank offered rates, LIBOR in particular. In the U.S., the Alternative Reference Rates Committee (ARRC) convened by the Federal Reserve Board has recommended SOFR as the preferred alternative to LIBOR. Reference rate reform has had, and will continue to have, broad reaching effects on entities that have assets, debt instruments, interest rate swap agreements or other contracts that reference or referenced LIBOR or another rate that has been or is expected to be discontinued.

Given the prevalence of LIBOR and other interbank offered rates, the volume of contracts that had to be modified to replace these reference rates with alternative rates, and would therefore be subject to U.S.

GAAP on contract modifications, would have been overwhelming for many entities. In addition, changes in a reference rate could affect the application of hedge accounting, and certain hedging relationships may not qualify as highly effective during the period of the market-wide transition to a replacement rate. To address these concerns, on March 12, 2020, the FASB issued the ASU. The ASU provides temporary optional expedients and exceptions to U.S. GAAP on contract modifications, hedge accounting and other transactions to ease the expected burden on financial reporting related to reference rate reform. The guidance in the ASU applies to all entities and simplifies the accounting when modifying contracts (including those in hedging relationships) that refer or referred to LIBOR or another reference rate that has been or is expected to be discontinued as a result of reference rate reform.

The ASU became effective upon its issuance on March 12, 2020. However, it cannot be applied to contract modifications that occur after December 31, 2024. With certain exceptions, the ASU also cannot be applied to hedging relationships entered into or evaluated after that date.

D. Applicability

The guidance in the ASU, if elected by an entity, applies to contracts or other transactions that reference or referenced LIBOR or a reference rate that has been or is expected to be discontinued as a result of reference rate reform. ASC 848-10-15-4 provides guidance that is useful in determining if a non-LIBOR reference rate is expected to be discontinued.

E. Contract modifications

Contracts that reference LIBOR, or another rate that is expected to be discontinued, will likely need to be modified to reference a replacement rate. U.S. GAAP addresses the accounting for contract modifications in various sections of the FASB's Accounting Standards Codification (ASC). As an option to applying the relevant modification guidance, entities may elect to apply the relief provided in ASC 848-20, *Reference Rate Reform – Contract Modifications*, if, as noted in ASC 848-20-15-2, the terms of the contract that are modified directly replace, or have the potential to replace, a rate that is expected to be discontinued as a consequence of reference rate reform with another interest rate index. The modification of a contract to replace a reference to LIBOR with a reference to SOFR is an example of a direct replacement of a reference rate with another interest rate index.

As noted in ASC 848-20-15-3, if other terms are contemporaneously modified in a manner that changes, or has the potential to change, the amount or timing of contractual cash flows, the optional relief provided in ASC 848-20 only applies if those modifications are related to the replacement of a reference rate. An example of a modification that is related to the replacement of a reference rate is the addition of a prepayment option for which exercise is contingent upon the reference interest rate no longer being determinable. As a result, an entity may apply the guidance in ASC 848-20 to such a modification.

The guidance in ASC 848-20 does not apply if a contract modification is made that is unrelated to the replacement of a reference rate, even if the unrelated change is made contemporaneously with modifications that are related to the replacement of a reference rate. However, contemporaneous modifications of contract terms that do not change or have the potential to change the amount or timing of contractual cash flows do not preclude applying the guidance in ASC 848-20 to otherwise qualified modifications.

It may not be straightforward to distinguish between changes to contractual terms that are considered related to replacing a reference rate and those that are considered not related to replacing a reference rate. As a result, the FASB included examples of both in the ASU.

The FASB's examples of contract modifications that are considered related to replacing a reference rate (which is not meant to be an all-inclusive list) are included in ASC 848-20-15-5:

> 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. Examples of changes to terms that are related to the replacement of a reference rate in accordance with the guidance in paragraph 848-20-15-2 include the following:
>
> a. Changes to the referenced interest rate index (for example, a change from London Interbank Offered Rate [LIBOR] to another interest rate index)
>
> b. Addition of or changes to a spread adjustment (for example, adding or adjusting a spread to the interest rate index, amending the fixed rate for an interest rate swap, or paying or receiving a cash settlement for any difference intended to compensate for the difference in reference rates)
>
> c. Changes to the reset period, reset dates, day-count conventions, business-day conventions, payment dates, payment frequency, and repricing calculation (for example, a change from a forward-looking term rate to an overnight rate or a compounded overnight rate in arrears)
>
> d. Changes to the strike price of an existing interest rate option (including an embedded interest rate option)
>
> e. 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
>
> f. 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
>
> g. 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
>
> h. Changes to terms (including those in the examples in paragraph 848-20-15-6) that are necessary to comply with laws or regulations or to align with market conventions for the replacement rate.

Changes to contractual fallback terms (see ASC 848-20-15-5(g) in the preceding list) are discussed further in Section E.1.

The FASB's examples of contract modifications that are not considered related to replacing a reference rate (which is not meant to be an all-inclusive list) are included in ASC 848-20-15-6:

> Examples of changes to terms that are generally unrelated to the replacement of a reference rate in accordance with paragraph 848-20-15-3 include the following:
>
> a. Changes to the notional amount
>
> b. Changes to the maturity date
>
> c. Changes from a referenced interest rate index to a stated fixed rate
>
> d. Changes to the loan structure (for example, changing a term loan to a revolver loan)
>
> e. The addition of an underlying or variable unrelated to the referenced rate index (for example, addition of payments that are indexed to the price of gold)
>
> f. 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
>
> g. A concession granted to a debtor experiencing financial difficulty
>
> h. 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
>
> i. The addition or removal of a feature that is intended to provide leverage

j. Changes to the counterparty except in accordance with paragraphs 815-20-55-56A, 815-25-40-1A, and 815-30-40-1A

k. Changes to the priority or seniority of an obligation in the event of a default or a liquidation event

l. The addition or termination of a right to use one or more underlying assets in a lease contract

m. Changes to renewal, termination, or purchase option provisions in a lease contract

Changes from a referenced rate index to a fixed rate index (see ASC 848-20-15-6(c) in the preceding list) are discussed further in section E.2.

E.1 Changes to contractual fallback terms

Fallback terms refer to the contractual provisions that describe the process through which a replacement rate will be determined if a reference rate becomes unavailable (as LIBOR did). Fallback terms generally include all of the following:

- Circumstances that would trigger the replacement of a reference rate
- The new reference rate
- Any spread (positive or negative) that would be added to the replacement rate, which may differ from the spread associated with the original reference rate to account for differences between it and the replacement reference rate

As noted earlier in ASC 848-20-15-5(g), the 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 (e.g., the ARRC or International Swap Dealers Association [ISDA]) are considered related to reference rate reform. The fallback terms developed by these groups are only published after consulting with market participants and considering stakeholder feedback. Recommendations from the ARRC regarding fallback terms included in contracts for a variety of products may be found under ARRC Publications. ISDA also has helpful information about the transition from LIBOR, including fallback terms.

An entity may modify a contract to add or modify contractual fallback terms in a way that is not entirely consistent with fallback terms developed by a regulator or by a private-sector working group convened by a regulator. In this case, the entity must assess whether the fallback terms include, or could include, a term that is considered to be unrelated to reference rate reform. If the entity identifies a term that is considered to be unrelated to reference rate reform, it may disregard that term if, at the time the contractual fallback terms are added or amended, the entity determines that activation of the term unrelated to reference rate reform is not probable.

E.2 Changes from a referenced rate index to a fixed rate

If a contract has existing contractual fallback terms that replace the current reference rate with a fixed rate when the current reference rate is discontinued, modifying those contractual fallback terms to replace the fixed rate with a new interest rate index is considered related to the replacement of the reference rate.

As noted earlier in ASC 848-20-15-6(c), replacing a referenced rate index with a fixed rate is considered to be unrelated to reference rate reform. This is because there could be various business reasons, unrelated to reference rate reform, to change from a variable to a fixed rate. However, the selection of a rate that is the last published rate of an interest rate index that is discontinued is not considered a stated fixed rate for the purpose of applying ASC 848-20. For example, a change to reference the last published LIBOR rate is not considered unrelated to reference rate reform.

E.3 Optional expedients

If the previously discussed criteria in ASC 848-20-15-2 and 15-3 are met, the guidance in ASC 848-20 provides optional expedients for applying existing guidance under the following ASC topics to modifications of contracts that reference LIBOR or another reference rate that is expected to be discontinued as a result of reference rate reform. If an entity elects to apply an optional expedient for contract modifications, the entity is required to apply the expedient to all qualifying contract modifications that otherwise would be accounted for in accordance with the same topic or industry subtopic.

Through its outreach, the FASB determined that contracts within the scope of the following ASC topics would likely be greatly impacted by reference rate reform, and that entities would benefit from optional expedients related to the modification accounting guidance within those topics:

- ASC 310, *Receivables*: If an entity elects the expedient for receivables or loans, it accounts for all contracts within the scope of ASC 310 that were modified and qualify for the expedient as if the modifications were only minor, in accordance with ASC 310-20-35-10.
- ASC 470, *Debt*: If an entity elects the expedient for issued debt, it accounts for all modifications of its issued debt that do not meet the definition of a troubled debt restructuring and that qualify for the expedient as if those modifications were not substantial (ASC 470-50, *Debt – Modifications and Extinguishments*). This means that a modification is accounted for prospectively by adjusting the effective interest rate for the debt. For example, if issued debt is modified to refer to a different reference rate, an entity could elect to account for that modification prospectively by adjusting the effective interest rate. In other words, in this case, the entity is not required to analyze whether the modification should be accounted for as a debt modification or extinguishment.
- ASC 842, *Leases*: If an entity elects the expedient for leases accounted for under ASC 842, it accounts for all modifications to those contracts that qualify for the expedient as a continuation of the existing leases without reassessing lease classification or the discount rate, remeasuring lease payments or making other reassessments or remeasurements.

  For lessees, modifying the reference rate on which variable lease payments are based does not require an entity to remeasure the lease liability. The change in the reference rate should be treated in the same manner as the variable lease payments were treated prior to the change.
- *Embedded derivatives in the scope of ASC 815, Derivatives and Hedging:* When a contract is modified and qualifies for this expedient, election of the expedient results in the entity not reassessing any of its original conclusions 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 other words, election of the expedient results in the entity not reperforming the embedded derivative analysis that would otherwise be required by ASC 815-15, *Derivatives and Hedging – Embedded Derivatives*, when any of the qualifying contracts are modified.

A contract modification that does not qualify for an optional expedient does not preclude the application of an optional expedient to contract modifications that do qualify.

In ASC 848-20-35-4, the FASB also has provided relief for contracts that are modified but do not fall within the scope of ASC 310, 470 or 842. However, this relief may only be applied if the modified terms of the contract directly replace, or have the potential to replace, a reference rate that is expected to be discontinued as a result of reference rate reform, and the requirements in ASC 848-20-15-2 and 15-3 are otherwise met. When a contract modification qualifies for this relief, an entity may account for the modification as an event that does not require contract remeasurement at the modification date or reassessment of a previous accounting determination required under the otherwise applicable U.S. GAAP. Although the table that follows is not meant to be all inclusive, the FASB provided it in ASC 848-20-55-2 to illustrate potential outcomes of applying this relief.

Contract or Instrument Modified as a Result of Reference Rate Reform	Potential Outcome of Applying Paragraph 848-20-35-4
An instrument accounted for as a derivative instrument in accordance with Topic 815, *Derivatives and Hedging*	An entity should not reassess the modified instrument to determine whether it is a hybrid instrument and whether it includes a financing element in accordance with paragraphs 815-10-45-11 through 45-15. The modified instrument should be accounted for and presented in the same manner as the instrument existing before the modification.
A contract issued by an insurance entity and accounted for in accordance with Topic 944, *Financial Services - Insurance*	An entity should not reassess the modified contract to determine whether it is substantially unchanged in accordance with Subtopic 944-30. The modified contract should be accounted for and presented as a continuation of the contract existing before the modification.
A contract accounted for in accordance with Topic 606, *Revenue from Contracts with Customers*	An entity should not reassess the modified contract in accordance with the contract modification guidance in paragraphs 606-10-25-10 through 25-13. Cash flow changes resulting from variability in the replacement reference rate should be accounted for and presented in the same manner as the cash flow changes that resulted from variability in the replaced reference rate before the modification for reference rate reform.
A contract with a counterparty entity that is within the scope of the Variable Interest Entities (VIE) Subsections in accordance with Topic 810, *Consolidation*	An entity should not reconsider the determination of the counterparty entity's VIE status in accordance with paragraph 810-10-35-4. The counterparty entity's VIE status should remain unchanged from the VIE status determined before the modification.

F. Hedge accounting

The discontinuation of LIBOR impacted most hedges of interest rate risk, given that many interest rate derivatives (e.g., swaps, caps) that are currently outstanding, and the variable-rate debt they may be hedging, were referenced to LIBOR. As such, LIBOR was or will be replaced by an alternate reference rate either through existing fallback language in those contracts in which it is referenced or through modifications to those contracts. Given that derivatives such as interest rate swaps are separate contracts from the debt instruments they are hedging, the FASB understood that it was quite possible that transition of a particular derivative and the debt that it hedges may not occur simultaneously and that the terms of the replacement rate for the derivative may not match the terms for the replacement rate of the item it is hedging. Both of these circumstances could cause a hedging relationship to not be highly effective. Additionally, as noted in ASC 815-20-55-56, generally, when an entity changes the critical terms of a hedging relationship, it must discontinue hedge accounting for that hedging relationship, but it may be able to designate a new hedging relationship. Given the consequences of applying this guidance to hedging relationships affected by reference rate reform, ASC 848 contains several exceptions and optional expedients that may be applied to hedging relationships.

Unlike the guidance on contract modifications in the ASU, the hedging optional expedients may be applied on an individual hedge relationship basis. That is, if an entity elects to apply an expedient to a particular hedging relationship, it does not have to apply that same expedient to all similar hedging relationships. In addition, an entity may pick and choose the different optional expedients to apply on an individual hedging relationship basis. For example, for a particular hedging relationship, an entity may

elect to apply the expedient to change the designated benchmark interest rate and not elect to apply the expedient for the shortcut method for assessing effectiveness.

Entities should carefully consider the exceptions and optional expedients in the ASU, as applying one or more of them could make the difference between being able to continue applying hedge accounting and being required to discontinue hedge accounting.

The remainder of this section provides a high-level summary of these hedge accounting exceptions and optional expedients (see ASC 848-30, *Reference Rate Reform – Hedging—General;* ASC 848-40, *Reference Rate Reform – Fair Value Hedges*; and ASC 848-50, *Reference Rate Reform – Cash Flow Hedges* for further guidance regarding implementation of these exceptions and expedients).

F.1 Scope of the ASU for hedging relationships

Entities may apply the guidance in the ASU only to hedging relationships that have a hedging instrument, hedged item or hedged forecasted transaction that references a rate that is expected to be discontinued as a result of reference rate reform.

F.2 Updating formal hedge documentation

ASC 815-20-25-3 requires formal designation and documentation of a hedge at hedge inception to qualify for hedge accounting. ASC 815-20-55-56 indicates that if an entity wishes to change any critical terms of the hedging relationship as documented at inception, including a term associated with the derivative or the item it is hedging or the method of assessing effectiveness, the hedge relationship would need to be dedesignated, and a new hedge relationship designated with the desired changes. Under ASC 848-30-25-3, an entity may update its hedge documentation for a change in critical terms attributable to electing optional expedients related to hedge accounting that are discussed in the paragraphs that follow. Under this expedient, such a change to the formal hedge documentation in and of itself would not be considered a dedesignation of the hedging relationship. In accordance with ASC 848-30-25-4, if this expedient is elected, the entity should update its hedge documentation to note the change no later than when it performs its first assessment of effectiveness after the change was identified.

F.3 Optional expedients related to amending the critical terms of a hedging relationship

The expedients that follow, which permit amending the critical terms of a hedging relationship without dedesignating the hedging relationship, do not apply to amendments made after December 31, 2024.

F.3.1 Changes to the contractual terms of the hedging instrument, hedged item or forecasted transaction

ASC 848-30-25-5 permits an entity to continue hedge accounting without dedesignating a hedging relationship if the entity changes the contractual terms of the hedging instrument, hedged item or forecasted transaction that is affected or expected to be affected by reference rate reform (e.g., modifying an interest rate swap to replace LIBOR with SOFR as the reference rate). Any changes to the contractual terms of the hedging instrument, hedged item or forecasted transaction must be solely related to the replacement of a reference rate expected to be discontinued as a result of reference rate reform, as elaborated on in ASC 848-20-15-2 and 15-3. This expedient applies to all types of hedging relationships (i.e., fair value hedges, cash flow hedges and net investment hedges).

As noted in ASC 848-30-25-6, the terms of a derivative contract may be changed by directly modifying its terms or entering into an offsetting derivative contract to effectively cancel the original derivative contract, while contemporaneously entering into a new derivative with revised contractual terms.

As noted in ASC 848-30-25-7, a change to the interest rate used for margining, discounting or contract price alignment for a derivative designated as a hedging instrument is not a change to the critical terms of the hedging relationship that requires dedesignating the hedging relationship.

F.3.2 Changing the designated method of assessing the effectiveness of a cash flow hedge

ASC 848-30-25-8 allows an entity to change its method used for assessing hedge effectiveness if either the hedging instrument or the hedged forecasted transaction references a rate that is expected to be discontinued as a result of reference rate reform, and the new method of assessing effectiveness is one of several optional expedients that are provided for in ASC 848-50 (which is discussed in Section F.5.3). In other words, an entity could switch to the shortcut method or elect a different optional expedient to adjust the requirements to assume perfect effectiveness for other methods such that it may ignore differences between the hedged forecasted interest payments and the derivative instrument that are due to the changes in the reference rates and the timing of when the rates reset.

An entity is not required to assess whether the new method is an improved method for assessing effectiveness or a preferable method of applying an accounting principle in accordance with ASC 250, *Accounting Changes and Error Corrections*.

As noted in Section J, the ability to ignore differences in reference rates and reset dates is temporary relief, and when it may no longer be applied an entity may once again change its method of subsequently assessing hedge effectiveness.

F.3.3 Rebalancing hedging relationships

An entity may wish to rebalance a hedging relationship that is affected or expected to be affected by reference rate reform so that it continues to be effective. Specifically, ASC 848-30-25-9 to 25-11A permits an entity to rebalance cash flow hedges and fair value hedges if the hedging instrument, hedged forecasted transaction (for cash flow hedges) or designated benchmark interest rate (for fair value hedges) references a rate that is expected to be discontinued as a result of reference rate reform.

For fair value hedges only, an entity may change the designated notional amount of the derivative hedging instrument, the designated portion of the hedged item or both.

For cash flow hedges and fair value hedges, an entity may change the designated hedging instrument by adding one or more derivatives or proportions thereof to be jointly designated along with the original hedging instrument. For example, if an entity had designated a LIBOR-based interest rate swap as the hedging instrument in a cash flow hedge, and it later changed the designated hedged risk from LIBOR to SOFR prior to the cessation of LIBOR, the entity could have entered into a LIBOR-SOFR-basis swap and jointly designate the basis swap and the LIBOR swap as the new hedging instrument.

ASC 848-30-25-9 to 25-11 addresses accounting for fair value hedge basis adjustments and the assessment of hedge effectiveness after rebalancing hedging relationships.

F.3.4 Excluded components

Often entities exclude all or certain components of a hedging derivative’s time value (e.g., the forward points of a forward contract) from the assessment of hedge effectiveness to increase the likelihood of the hedge relationship being highly effective. An entity may elect to recognize the changes in the fair value of the excluded component currently in earnings, and if such an election is not made, the changes in the fair value of the excluded component are recognized in accumulated other comprehensive income (AOCI) and reclassified to earnings using a systematic and rational method.

Replacing the reference rate of a hedging instrument with another reference rate could affect the fair value of the excluded component, which in turn would affect the amounts reclassified from AOCI to earnings. ASC 848-30-25-12 allows an entity to prospectively change the systematic and rational method it uses for the reclassification, provided any modifications to the hedging instrument’s contractual terms meet the scope requirements of ASC 848-20-15-2 and 15-3. The amended systematic and rational method may be subsequently amended for additional changes to a hedging instrument’s contractual terms that meet these scope requirements.

If an entity does not apply this expedient, a cumulative catch-up adjustment may be required so that no amounts related to the excluded component remain in AOCI at the end of the hedging relationship.

If changing the contractual terms of a hedging instrument changes the fair value of the excluded component, an entity may elect to recognize that change in fair value in current earnings in accordance with ASC 848-30-25-13. The recognition of this adjustment should be presented in the same income statement line item that captures the earnings effect of the hedged item.

This expedient applies to fair value hedges, cash flow hedges and net investment hedges. If an amended systematic and rational method is elected, it must be applied for the remaining life of the hedging relationship, including periods subsequent to December 31, 2024.

F.4 Other optional expedients related to fair value hedges

ASC 848-40 provides optional expedients for fair value hedging relationships that are affected by reference rate reform. An entity may apply these expedients without dedesignating the hedging relationship, but, as previously noted, the entity would need to update its hedge documentation.

F.4.1 Changing the designated benchmark rate

For hedging relationships where the designated risk is changes in fair value attributable to a benchmark interest rate, and the referenced interest rate index of the hedging instrument changes due to reference rate reform, under ASC 848-40-25-2, an entity may change the designated benchmark interest rate to another permitted benchmark rate. This may only be done if the hedging instrument is expected to be highly effective at achieving offsetting changes in fair value attributable to the revised hedged risk on the basis of the revised terms.

In a fair value hedge, the carrying amount of the hedged item is adjusted for changes in its fair value that are attributable to the designated hedged risk. If an entity changes the designated benchmark interest rate of a fair value hedging relationship, the adjustment to the carrying amount of the hedged item will be impacted. ASC 848-40-25-4 to 25-7 provides further guidance on accounting for the basis adjustment to the hedged item when applying this expedient, including application issues related to the accounting subsequent to December 31, 2024.

F.4.2 Shortcut method for existing hedges

The shortcut method allows an entity to assume that a hedging relationship is perfectly effective if certain conditions are met. Under ASC 848-40-25-8, when determining if the hedging relationship continues to qualify for the shortcut method upon a change in the contractual terms of the interest rate swap, an entity may ignore the conditions in ASC 815-20-25-104 that would otherwise require:

- Consistent computation of net settlements under the interest rate swap
- The terms to be typical and not invalidate the assumption of perfect effectiveness

An entity may elect this expedient if the interest rate swap is modified to replace a rate that is affected or expected to be affected by reference rate reform and the modifications meet the scope requirements of ASC 848-20-15-2 and 15-3.

This expedient may be applied for the life of the hedging relationship, which could extend beyond December 31, 2024.

F.5 Other optional expedients related to cash flow hedges

ASC 848-50 provides optional expedients for cash flow hedging relationships affected by reference rate reform. An entity may apply these expedients without dedesignating the hedging relationship.

F.5.1 Probability of the hedged forecasted transaction

To apply hedge accounting for a forecasted transaction, such as future interest payments on variable-rate debt, an entity must be able to assert that the forecasted transaction (as described in its formal inception-date hedge documentation) is probable of occurring. A change in the probability of a forecasted transaction may require an entity to discontinue hedge accounting and could accelerate the timing of recognizing in earnings the amounts that are deferred in AOCI.

For hedging relationships in which the designated hedged interest rate risk is a rate that is expected to be discontinued by reference rate reform, an entity may continue to assert that the occurrence of the hedged forecasted transaction as originally documented remains probable under ASC 848-50-25-2, even though the reference rate for the interest payments is modified or expected to be modified. This optional expedient is not available for forecasted transactions that are no longer probable of occurring.

F.5.2 Changing the designated hedged risk

ASC 815-30-35-37A indicates that the designated hedged risk for a cash flow hedge may change during a hedging relationship, but an entity may continue to apply hedge accounting if the hedging relationship remains highly effective. ASC 848-50-25-3 clarifies that if the designated hedged interest rate risk is a rate that is affected by reference rate reform, an entity may change the designated hedged interest rate risk by updating its hedge documentation and continue hedge accounting if the hedge remains highly effective (as demonstrated using the method selected at hedge inception or an optional expedient method in the ASU that may be elected).

F.5.3 Initial and subsequent assessment of effectiveness

ASC 815-20-25-3(b)(2)(iv)(01) requires an entity to perform an initial quantitative assessment of hedge effectiveness unless one of eight methods it lists is applied, such that the entity can assume perfect effectiveness qualitatively. For hedging relationships for which either the hedging instrument (e.g., interest rate swap or cap) or hedged forecasted transactions (e.g., interest payments) reference a rate such as LIBOR that is expected to be discontinued as a result of reference rate reform, under ASC 848-50-25-6 to 25-10, an entity may adjust how it applies the methods that are relevant to hedges of interest rate risk, including disregarding certain conditions or mismatches between the designated hedging instrument and the hedged item when performing the initial assessment of hedge effectiveness for a new hedge. This includes the adjustments related to the application of the shortcut method and the simplified approach for private companies that are discussed in Sections F.5.3.1 and F.5.3.2, respectively, as well as the application of other methods in ASC 815-20-25-3(b)(2)(iv)(01) that pertain to hedges of interest rate risk (namely, the terminal value method for options such as interest rate caps and the change in variable cash flows and hypothetical derivative methods for interest rate swaps). ASC 848-50-25-11 and 25-12 provide similar optional expedients for entities that use a quantitative method of assessing effectiveness for the initial assessment, and ASC 848-50-35 provides optional expedients for the subsequent assessments of effectiveness. An entity that elects to change its method of assessing effectiveness to one of the optional expedients in ASC 848-50-35 should update its hedge documentation.

F.5.3.1 Shortcut method

As mentioned earlier, the shortcut method allows an entity to assume its hedges involving an interest rate swap as the hedging instrument are perfectively effective if certain conditions are met. ASC 848-50 provides an optional expedient to allow an entity to apply the shortcut method for cash flow hedges that reference a rate that is expected to be discontinued due to reference rate reform.

Under the optional expedient provided in ASC 848-50-25-6 (for the initial assessment of effectiveness) and ASC 848-50-35-5 (for the subsequent assessments), an entity may ignore the conditions in ASC 815-20-25-104 and 25-106 that would otherwise require:

- Consistent computation of net settlements under the interest rate swap
- The terms of the interest rate swap to be typical and not invalidate the assumption of perfect effectiveness
- The repricing dates of the variable-rate asset or variable-rate liability and the hedging instrument to occur on the same dates and be calculated the same way
- The index on which the variable leg of the interest rate swap is based to match the contractually specified interest rate designated as the interest rate being hedged for that hedging relationship

F.5.3.2 Simplified approach for certain private companies

The simplified approach described in ASC 815-20-25-133 to 25-138 allows eligible private companies to assume that their cash flow hedges that use a receive-variable pay-fixed interest rate swap to hedge a variable-rate borrowing are perfectively effective if certain conditions are met. Under ASC 848-50-25-8 (for the initial assessment) and ASC 848-50-35-7 (for the subsequent assessments), if such a cash flow hedge is affected by reference rate reform, a private company may ignore the following otherwise required conditions:

- Both the variable rate on the swap and the borrowing are based on the same index and reset period
- The terms of the swap are typical
- The repricing and settlement dates for the swap and the borrowing match

F.5.3.3 Other methods of assessing the effectiveness of cash flow hedges

Expedients similar to those previously discussed in the context of the shortcut method and simplified approach for certain private companies are provided for other methods of assessing effectiveness for cash flow hedges. For hedges that involve an option as the hedging instrument (e.g., interest rate cap or floor), the expedients pertain to the application of the terminal value method and are discussed in ASC 848-50-25-7 and 25-12 (for the initial assessments of effectiveness) and ASC 848-50-35-6 and 35-18 (for the subsequent assessments of effectiveness). For hedges that involve an interest rate swap as the hedging instrument, the expedients relate to the application of the following methods, discussed beginning at ASC 848-50-25-9 to 25-11 (for the initial assessments) and ASC 848-50-35-8, 35-9 and 35-17 (for the subsequent assessments):

- Change-in-variable-cash-flows method
- Hypothetical derivative method
- Change-in-fair-value method

F.5.4 Switching from a quantitative assessment to qualitative

The guidance that begins at ASC 815-20-35-2A permits an entity to assess hedge effectiveness qualitatively, after performing an initial quantitative assessment of hedge effectiveness. As an optional expedient in ASC 848-50-35-1, the requirements in ASC 815-20-35-2A to 35-2F may be disregarded. Instead, under the guidance beginning at ASC 848-50-35-11, an entity may continue to assert qualitatively that it may continue to apply hedge accounting if: (a) the hedging instrument or forecasted transaction references LIBOR or another reference rate that is expected to be discontinued as a result of reference rate reform, (b) any modifications to the hedging instrument or forecasted transaction meet the aforementioned requirements of ASC 848-20-15-2 and 15-3 and (c) the entity considers the likelihood of the counterparty to comply with the contractual terms of the hedging derivative. If an entity assesses

hedge effectiveness qualitatively under this expedient, it must verify and document that the facts and circumstances have not changed, and that these criteria continue to be met, to continue to assess hedge effectiveness qualitatively. An entity must do this whenever it releases its financial statements or reports its earnings, and at least every three months.

If the facts and circumstances have changed such that the previously discussed criteria are no longer met, the entity may no longer assert qualitatively that the hedging relationship continues to qualify for hedge accounting. As a result, the entity must perform its assessment of effectiveness quantitatively in accordance with ASC 815-20, *Derivatives and Hedging – Hedging—General* or ASC 815-30, *Derivatives and Hedging – Cash Flow Hedges*, or a quantitative optional expedient within ASC 848-50.

F.5.5 Groups of forecasted transactions

For hedges of portfolios of forecasted transactions, such as interest payments on multiple borrowings, that are affected by reference rate reform, under ASC 848-50-25-13 and 25-14, an entity may disregard the requirement that the group of individual transactions must share the same risk exposure for which they are designated as being hedged if a forecasted transaction in the hedged group references LIBOR or another reference rate that is expected to be discontinued as a result of reference rate reform. However, ASC 848-50-25-14 points out that a forecasted purchase and a forecasted sale are not permitted to be included in the same group of hedged forecasted transactions. In addition, an entity is precluded from including forecasted interest receipts and forecasted interest payments in the same group of hedged forecasted transactions.

F.5.6 Discontinuance of optional expedients

After electing an optional expedient method of assessing hedge effectiveness, an entity may switch back to applying the hedge accounting requirements in ASC 815-20 and 815-30 without dedesignating the hedging relationship. However, its hedge documentation should be updated for the change.

It is important to note that use of the optional expedients for assessing hedge effectiveness (including the optional expedient for application of the shortcut method and other methods that assume perfect hedge effectiveness) must be discontinued in accordance with ASC 848-50-35-19 by the earlier of: (a) the date that neither the hedging instrument nor the hedged forecasted transaction references a rate that is expected to be discontinued as a result of reference rate reform or (b) the hedge effectiveness assessments performed after December 31, 2024.

An entity must return to applying the criteria and hedge effectiveness assessment methods in ASC 815-20 and 815-30 without adjustment to determine whether a cash flow hedge may continue after the entity discontinues or is required to discontinue applying an optional expedient method. However, the entity does not need to revert to the same effectiveness assessment method that it used before applying the optional expedient method. Under ASC 848-50-35-21, an entity may create the terms of the instrument used to estimate changes in the fair value of its hedged risk (e.g., the hypothetical derivative) based on market data as of the inception of the hedging relationship such that the off-market nature of the derivative at the time an optional expedient is discontinued would not in and of itself create ineffectiveness. In addition, throughout the entire term of the hedge relationship, an entity is required to continue to assess whether the hedged forecasted transaction remains probable of occurring.

If a new method is selected after discontinuing an optional expedient method, the entity need not discontinue the hedging relationship, but it must update its hedge documentation in the manner previously described in Section F.2.

If, at the time an entity discontinues an optional expedient method, the hedging relationship does not qualify for hedge accounting when applying an effectiveness assessment method in ASC 815-20 or 815-30, then the entity would discontinue hedge accounting prospectively and apply the guidance in ASC 815-30-40-2 to 40-6A.

G. Held-to-maturity securities

The FASB has responded to constituent feedback by allowing an entity under ASC 848-10-35-1 to make a one-time election to sell and (or) transfer debt securities classified as HTM to available-for-sale or trading if at the time of the election the debt security: (a) refers to LIBOR or another reference rate that is expected to be discontinued as a result of reference rate reform and (b) was classified as HTM before January 1, 2020. This one-time election may be made on a security-by-security basis no later than December 31, 2024.

Transfers of HTM securities should be measured in accordance with ASC 320-10-35-10 to 35-16. Both transfers and sales should be disclosed as required by ASC 320-10, *Investments—Debt and Equity Securities*. A sale or transfer made in accordance with this one-time election does not call into question the entity's prior assertion of an intent and ability to hold HTM securities to maturity.

H. Required disclosures

Entities that choose to apply the guidance in the ASU are required under ASC 848-10-65-1(e) to disclose the nature of the optional expedients and exceptions they are applying, as well as the reasons for doing so.

Entities that choose to apply the one-time election to sell and (or) transfer any debt security classified as HTM must satisfy the disclosure requirements in ASC 320-10-50-10.

I. Effective date and transition method

The effective date and transition method were established by the ASU as amended by ASU 2022-06. The ASU may be applied as of the beginning of the interim period that includes March 12, 2020. This means calendar-year-end entities may apply the guidance in the ASU on or after January 1, 2020.

An entity may elect to adopt the guidance in the ASU for contract modifications either:

- As of any date from the beginning of an interim period that includes or is subsequent to March 12, 2020
- Prospectively from a date within an interim period that includes or is subsequent to March 12, 2020, up to the date that the financial statements are available to be issued

As discussed in Section E, once an entity elects to apply the contract modification guidance in the ASU for a particular ASC topic or an industry subtopic, it must apply it prospectively for all qualifying contract modifications made prior to December 31, 2024 for that ASC topic or industry subtopic.

For hedge accounting relief, the guidance in the ASU may be applied to hedging relationships that exist as of the beginning of an interim period that includes March 12, 2020 and to new eligible hedging relationships designated in subsequent periods. However, the optional expedients may not be applied to hedging relationships entered into or evaluated after December 31, 2024, with the limited exceptions described in ASC 848-10-65-1(a)(3)(iii) and Section J.

The one-time election to sell and (or) transfer debt securities classified as HTM to available-for-sale or trading may be made after March 12, 2020 but no later than December 31, 2024.

The transition guidance for adopting the ASU may be found in ASC 848-10-65-1.

J. Sunset date

The guidance in the ASU, as amended by ASU 2022-06 generally does not apply to contract modifications made, hedging relationships entered into or evaluated, or sales and transfers of HTM debt securities after December 31, 2024. After this date, existing guidance relevant to contract modifications and hedging relationships should be applied.

The following may be applied over the remaining life of a hedging relationship, even if that life extends beyond December 31, 2024: (a) the optional expedient related to recognizing components excluded from the assessment of effectiveness in earnings and (b) for fair value hedges, the optional expedients related to the application of the shortcut method and to discounting the cash flows associated with the hedged item.

For cash flow hedges, entities must discontinue using the optional expedients for effectiveness assessment at the earliest of:

- The date that neither the hedged item nor hedging instrument reference a rate that is expected to be discontinued
- The date that the entity elects to stop applying the optional expedient
- Hedge effectiveness assessment periods after December 31, 2024

Upon the termination or discontinuance of the optional expedients, an entity should apply existing U.S. GAAP.

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