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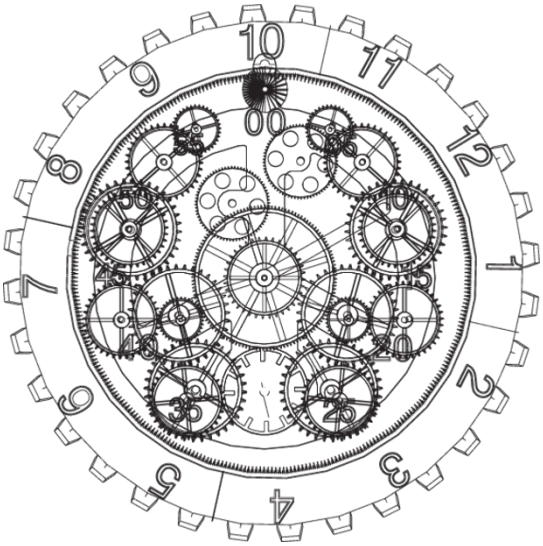

IFRS Newsletter

Bringing you the latest information on recent IFRS topics

We are pleased to welcome you to the new edition of our **IFRS Newsletter**.

Our aim is to keep you updated with all the latest news and developments on IFRS and financial reporting along with the potential impact they may have on your business.

In this issue we discuss:

IASB issues Interest Rate Benchmark Reform amendments to IFRS 9, IAS 39 and IFRS 7

We hope that you find our newsletter insightful and if you would like to discuss any of the topics covered, please do not hesitate to contact us.

Best regards

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Where can I go for more information?

This publication highlights just some of the recent IFRS topics that may be of interest to entities reporting under IFRS.

More detailed information can be found at www.iasplus.com

IASB issues Interest Rate Benchmark Reform amendments to IFRS 9, IAS 39 and IFRS 7

The International Accounting Standards Board (IASB) has published amendments to IFRS 9 *Financial Instruments*, IAS *39 Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*. The amendments are titled **Interest Rate Benchmark Reform—Amendments to IFRS 9, IAS 39 and IFRS 7**.

- The amendments will affect entities that apply the hedge accounting requirements of IFRS 9 or IAS 39 to hedging relationships directly affected by the interest rate benchmark reform.
- The amendments modify specific hedge accounting requirements, so that entities would apply those hedge accounting requirements assuming that the interest rate benchmark is not altered as a result of the interest rate benchmark reform.
- The changes will mandatorily apply to all hedging relationships that are directly affected by the interest rate benchmark reform.
- The amendments are not intended to provide relief from any other consequences arising from the interest rate benchmark reform. If a hedging relationship no longer meets the requirements for hedge accounting for reasons other than those specified by the amended Standards, then discontinuation of hedge accounting is still required.
- The amendments are effective for annual periods beginning on or after 1 January 2020, with earlier application permitted.
- The amendments are applied retrospectively to those hedging relationships that existed at the beginning of the reporting period in which an entity first applies the amendments or were designated thereafter, and to the gain or loss recognised in other comprehensive income that existed at the beginning of the reporting period in which an entity first applies the amendments.
- Differences between the Exposure Draft and the final amendments include relief from the retrospective assessment of hedge effectiveness (the '80–125% rule') when applying IAS 39, relief from the separately identifiable requirement for macro hedges, the inclusion of some foreign currency hedging in the scope of the amendments, and changes to the disclosure requirements.

Background

Interest rate benchmarks such as interbank offered rates (IBORs) play a key role in global financial markets and index trillions of dollars in financial products. However, work is underway in multiple jurisdictions to transition to alternative risk free rates (RFRs) as soon

as 2020. Several reasons have driven this move. Systemic risk concerns have been raised due to instances of fraudulent submissions by banks and underlying markets not being sufficiently active for some of the IBORs, together with the key reliance of financial transactions on these rates. Panel banks that provide submissions that contribute to IBOR are less comfortable providing those submissions when the volume of underlying transactions is low, due to potential litigation risks. All of these factors could lead to manipulation of rates and raise concerns over how these rates are determined in stressed market conditions.

Against this background, the G20 asked the Financial Stability Board (FSB) to undertake a fundamental review of major interest rate benchmarks. Following the review, the FSB published a report setting out its recommendations to reform some major interest rate benchmarks such as IBOR. As a result, alternative RFRs have been selected in key currency jurisdictions by working groups, with the objective that such rates will be based on liquid underlying market transactions, and not dependent on submissions based on expert judgement. This will result in rates that are more reliable and provide a robust alternative for products and transactions that do not need to incorporate the credit risk premium embedded in the IBORs. This has led to uncertainty about the long-term viability of some existing interest rate benchmarks.

Observation

The amendments address only the hedge accounting issues arising before IBOR is replaced with an alternative RFR, i.e. the pre-replacement issues. This has been referred to Phase I of the project. The amendments consider the implications for specific hedge accounting requirements in IFRS 9 and IAS 39, which require a forward-looking analysis and provide a relief during this period of uncertainty. In September 2019, the IASB started working on a project to address any issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative interest rate, i.e. replacement issues, being Phase II of the project. The first output from this phase of the project will be an exposure draft expected in the first half of 2020.

The amendments

The amendments to the hedge accounting requirements impact both IFRS 9 and IAS 39 because entities have an accounting policy choice under IFRS 9 as to whether to continue to apply the hedge accounting model in IAS 39 or IFRS 9. In addition, some insurance companies have not adopted IFRS 9 as they are deferring the application until they apply IFRS 17 *Insurance Contracts* so they continue to apply IAS 39 in its entirety. The IASB have modified specific hedge accounting requirements so that entities would apply those hedge accounting requirements assuming that the interest rate benchmark on which the hedged cash flows and cash flows of the hedging instrument are based is not altered as a result of the uncertainties of the interest rate benchmark reform. The amendments apply to all hedging relationships that are directly affected by the interest rate benchmark reform. Interest rate benchmark reform refers to the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate such as that resulting from the recommendations set out in the FSB's July 2014 report *Reforming Major Interest Rate Benchmarks*.

The amendments affect the following areas:

1. Highly probable requirement for cash flow hedges (IFRS 9 and IAS 39): If the hedged item is a forecast transaction, an entity shall determine whether the forecast transaction is highly probable assuming that the interest rate benchmark on which the hedged cash

flows are based is not altered as a result of the interest rate benchmark reform.

2. Reclassification of the amount in the cash flow hedge reserve to profit or loss (IFRS 9 and IAS 39): To determine whether the hedged cash flows are expected to occur, an entity shall assume that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of the interest rate benchmark reform.

3. Assessment of the economic relationship between the hedged item and the hedging instrument (IFRS 9): An entity shall assume that the interest rate benchmark on which the hedged cash flows and/or the hedged risk are based, or the interest rate benchmark on which the cash flows of the hedging instrument are based, are not altered as a result of the interest rate benchmark reform.

4. Prospective assessment and retrospective assessment (IAS 39): An entity shall assume that the interest rate benchmark on which the hedged cash flows and/or hedged risk are based, or the interest rate benchmark on which the cash flows of the hedging instrument are based, is not altered as a result of the interest rate benchmark reform.

An entity is not required to discontinue a hedging relationship during the period of uncertainty arising from the interest rate benchmark reform solely because the actual results of the hedge are not highly effective, i.e. are outside the range of 80-125% when applying the retrospective assessment. In such a situation, an entity shall apply the other conditions that are required for a hedging relationship to qualify for hedge accounting, including the prospective assessment, to assess whether the hedging relationship must be discontinued.

5. Designation of a component of an item as a hedged item (IFRS 9 and IAS 39J: For a hedge of a benchmark component of interest rate risk that is affected by the interest rate benchmark reform, an entity shall apply the specific requirement in IFRS 9 or IAS 39, to determine whether the risk component is separately identifiable, only at the inception of the hedging relationship. If the hedge is a dynamic hedge, where the entity frequently resets a hedging relationship, the risk component needs to be separately identifiable only on initial designation of the hedged item.

6. End of application of the relief (IFRS 9 and IAS 39): The amendments state the circumstances in which an entity shall prospectively cease applying each of the requirements set out in 1 to 5 above. For 1 to 4 above, the relief is applicable until the earlier of when the uncertainty around the timing and the amount of the cash flows arising from the interest rate benchmark reform is no longer present in the hedged item and hedging instrument, and when the hedging relationship is discontinued. For 5 above, the relief will end on termination of the hedging relationship.

7. Disclosures (IFRS 7): Entities will be required to disclose:

- the significant interest rate benchmarks to which the entity's hedging relationships are exposed;
- the extent of the risk exposure the entity manages that is affected by the interest rate benchmark reform;
- how the entity is managing the process to transition to alternative benchmark interest rates;
- a description of significant assumptions or judgements the entity made in applying the amendments to IFRS 9 and IAS 39; and

- the nominal amount of the hedging instrument in the hedging relationship for which the entity is applying the exceptions in the scope of the amendments.

Observation

The amendments aim to avoid disruption to existing cash flow and fair value hedge accounting relationships directly impacted by the reform that in the absence of the relief would result in hedge ineffectiveness and potential hedge accounting failures as result of IBORs being replaced by alternative RFRs. Such failures could have led to widespread reclassification of amounts in cash flow hedge reserves to profit or loss and cessation of fair value hedge accounting of fixed rate debt.

The amendments avoid this disruption for cash flow hedges by requiring that an entity continues to assume, for the purposes of the hedged item, that IBOR-based cash flows will continue beyond the period when they could potentially be replaced by an alternative RFR. This applies irrespective of whether the IBOR-based variability in cash flows arises from a non-contractual exposure, for example, a forecast debt issuance, or a contractual exposure, such as a recognised IBOR-based lending or borrowing. Even if an entity has a contractual exposure, there will often be uncertainty about the likelihood the entity will be exposed to those IBOR-based cash flows given the reforms may result in an expectation that the debt will be modified or fall-back provisions within the terms of the debt take effect when the IBOR benchmark ceases to exist.

Similarly, for fair value hedges, the amendments require that for the hedged item the IBOR designated risk continues even though it could potentially be replaced by an alternative RFR. This relief ensures continuity of fair value hedge accounting during a time when fixed rate debt may be increasingly priced using alternative RFRs as opposed to IBORs.

Should a derivative be modified so it is contractually based on the alternative RFR, instead of IBOR, then the relief ceases for the hedging instrument, as at this point the amendments deem that there is no longer uncertainty about IBOR being replaced for that instrument. At this point an entity may have the ability to designate the derivative based on RFR with the RFR-based hedged item. Alternatively, if the hedged item has not been modified and remains exposed to IBOR an entity could continue to apply the relief to the hedge relationship as the entity's hedged item continues to be exposed to the uncertainties of interest rate benchmark. However, in order to continue to apply hedge accounting with the relief, an entity would have to demonstrate that on a prospective basis it expects its RFR-based derivative to be highly effective at hedging its IBOR-based hedged item in the case of IAS 39, or in the case of IFRS 9 demonstrate that the RFR-based derivative and the IBOR-based hedged item have an economic relationship.

The IASB will consider the accounting implications of this new designation when it deliberates Phase II of the project.

Differences between the Exposure Draft and the final amendments

Based on the comment letters received to the Exposure Draft, the IASB made the following changes to the proposals in the Exposure Draft:

1. Retrospective assessment for those hedging relationships accounted for applying IAS 39: During the period of uncertainty arising from the interest rate benchmark reform, relief from the 80-125% rule has been provided.

2. Macro hedges: Relief has been provided from the separately identifiable requirement for macro hedges and clarity has been provided for when the relief ceases to apply to a group of items designated as the hedged item.

3. Scope of the amendments: The amendments now apply to hedge accounting directly affected by the interest rate benchmark reform which can include hedges of both interest rate and foreign currency risks given foreign currency denominated interest rate benchmarks are relevant for hedges of foreign currency risk. The Exposure Draft was restricted to hedges of interest rate risk only.

4. Disclosures: Changes were made to the disclosure requirements to give specific guidance on what an entity is required to disclose including relief from disclosing specific quantitative disclosures required by IAS 8 when an entity initially applies an accounting policy.

Effective date

An entity applies the amendments to IFRS 9, IAS 39 and IFRS 7 for annual periods beginning on or after 1 January 2020, with early application permitted. The amendments are applied retrospectively to those hedging relationships that existed at the beginning of the reporting period in which an entity first applies the amendments or were designated thereafter, and to the gain or loss recognised in other comprehensive income that existed at the beginning of the reporting period in which an entity first applies the amendments.