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FASB Issues ASU to Refine the Scope of ASC 848 in Response to Reference Rate Reform

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On January 7, 2021, the FASB issued ASU 2021-01,[1] which refines the scope of ASC 848[2] and clarifies some of its guidance as part of the Board's monitoring of global reference rate reform activities. The ASU permits entities to elect certain optional expedients and exceptions when accounting for derivative contracts and certain hedging relationships affected by changes in the interest rates used for discounting cash flows, for computing variation margin settlements, and for calculating price alignment interest (PAI[3]) in connection with reference rate reform activities under way in global financial markets (the "discounting transition").

Background

Global market participants are undertaking efforts to transition from using or referencing the London Interbank Offered Rate (LIBOR) and other interbank offered rates to using or referencing alternative reference rates. Such efforts have included changes made by certain central clearing parties (CCPs) to the interest rates used for discounting and for variation margin settlements and PAI. For example, on July 24, 2020, the Chicago Mercantile Exchange (CME) changed the interest rate used in certain euro contracts for discounting and PAI from the Euro Overnight Index Average (EONIA) to the Euro Short-Term Rate (ESTR). In addition, on October 16, 2020, the CME changed the interest rate used in U.S. dollar contracts for discounting and PAI from the daily Effective Federal Funds Rate (EFFR) to the Secured

[1] FASB Accounting Standards Update (ASU) No. 2021-01, *Reference Rate Reform (Topic 848): Scope*.
[2] For titles of *FASB Accounting Standards Codification* (ASC or the "Codification") references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."
[3] PAI is also referred to as the price alignment amount (PAA) by the London Clearing House, and price alignment (PA) by the Chicago Mercantile Exchange.

Overnight Financing Rate (SOFR).[4] Interest rate transitions such as the CME's changes do not necessarily replace reference rates that are expected to be discontinued (e.g., the daily EFFR is not expected to be discontinued), and they are not limited to contracts that reference a rate that is expected to be discontinued (e.g., the CME's interest rate transition applies to all U.S. dollar interest rate products, not only those that reference LIBOR or another rate that is expected to be discontinued). The CME's interest rate transitions, for example, are intended to increase the trading volume in alternative reference rates (e.g., ESTR and SOFR).

The discounting transition may also affect collateralized bilateral derivative transactions, not all of which are indexed to a rate that will be discontinued as a result of reference rate reform. ASU 2021-01 is intended to reduce diversity in practice related to accounting for (1) modifications to the terms of affected derivatives and (2) existing hedging relationships in which the affected derivatives are designated as hedging instruments.

This *Heads Up* should be read alongside Deloitte's March 23, 2020, *Heads Up*.

Main Provisions of the Amendments

Scope (ASC 848-10)

The FASB acknowledges that not all derivative contracts subject to the discounting transition reference LIBOR or other interbank offered rates that are expected to be discontinued. For example, the discounting transition will affect derivative contracts that currently reference and will continue to reference other interest rates (e.g., EFFR, SOFR, the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate). However, the current scope of ASC 848 does not include such contracts. As stated in paragraph BC10 of ASU 2021-01, ASC 848 was intended to provide relief related to "contracts and transactions that reference LIBOR or a reference rate that is expected to be discontinued as a result of reference rate reform." Accordingly, ASU 2021-01 expands the scope of ASC 848 to include all affected derivatives and give market participants the ability to apply certain aspects of the contract modification and hedge accounting expedients to derivative contracts affected by the discounting transition.

In addition, ASU 2021-01 adds implementation guidance (codified in ASC 848-10-55-1) to clarify which optional expedients in ASC 848 may be applied to derivative instruments that do not reference LIBOR or a reference rate that is expected to be discontinued, but that are being modified as a result of the discounting transition. For more information, see the appendix of this *Heads Up*.

Contract Modifications (ASC 848-20)

ASC 848-20-35-1 currently indicates that an entity that elects to use a contract modification expedient under a particular Codification topic, subtopic, or industry subtopic must apply the expedient to all contract modifications accounted for under that guidance. ASU 2021-01 states that the election to apply the contract modification expedients to the modifications related to the discounting transition is separate from the election to apply the contract modification expedients to modifications related to broader reference rate reform activities. The ASU also clarifies that if an entity elects the contract modification expedients in ASC 848 to modifications resulting from the discounting transition, it must apply those expedients to all discounting transition modifications.

Connecting the Dots

ASC 848-20-35-4 and ASC 848-20-55-2 can be applied to derivative contracts affected by the discounting transition. That is, an entity can conclude that a contract previously determined to be a derivative in accordance with ASC 815 continues to meet the definition of a derivative and not a hybrid instrument in situations in which the terms

[4] See the CME Group's "SOFR Discounting Transition Process for Cleared Swaps," August 2020.

of the contract change as a result of the discounting transition. Further, in accordance with ASC 815-10-45-11 through 45-15, an entity does not need to reassess whether the contract includes a financing element.

Hedging — General (ASC 848-30)

ASU 2021-01 permits an entity to elect certain hedging relief if it has designated a derivative as a hedging instrument in a hedging relationship and the terms of the derivative (e.g., discount rate) have changed as a result of the discounting transition.

Connecting the Dots

In situations in which a derivative is designated as a hedging instrument in a hedging relationship and the interest rate used for discounting cash flows to calculate variation margin settlements and PAI has changed as a result of the discounting transition, questions have arisen about whether the change was made to critical terms of the hedging relationship. ASU 2021-01 clarifies that ASC 848-30-25-7 continues to apply to the affected derivative; that is, a change in the interest rate as a result of the discounting transition would not be considered a change to the critical terms of a hedging relationship. An entity can continue to apply hedge accounting without dedesignating the existing hedging relationship (see newly added ASC 848-10-55-1).

A cash settlement (or equivalent) may be exchanged to neutralize the change in the fair value of a derivative affected by the discounting transition. If such a derivative is designated as a hedging instrument in a cash flow hedging relationship, that cash settlement may create a mismatch between the fair value of the hedging instrument and the amount deferred in accumulated other comprehensive income (AOCI).

Under ASU 2021-01, an entity that assesses hedge effectiveness of a cash flow hedging relationship by using a method that allows an assumption of perfect hedge effectiveness is permitted to elect the relevant optional expedients and subsequently apply the original effectiveness assessment method under which it continues to assume that the hedge is perfectly effective after the discounting transition. Alternatively, the entity can elect to change to any applicable quantitative method of assessing the effectiveness of a cash flow hedge in ASC 815-20 and ASC 815-30 without dedesignating the hedging relationship. The ASU requires an entity that originally applied a quantitative or qualitative method in accordance with ASC 815-20 and ASC 815-30 to continue to apply the same method when performing its subsequent effectiveness assessment of a cash flow hedging relationship that was affected by the discounting transition.

In addition, for all cash flow hedging relationships affected by the discounting transition, an entity can use a reasonable approach to adjust the amount recorded in AOCI for the cash settlement (or equivalent) as a result of the discounting transition. Any adjustment to AOCI would be recognized in the income statement in the same manner as other reclassifications out of AOCI related to the hedging relationship.

Connecting the Dots

The ASU and ASC 848 do not specify the method an entity should use to adjust the amount in AOCI for the cash settlement (or equivalent) as a result of the discounting transition; rather, they only require the use of a reasonable method. However, an entity should apply its elected method consistently to similar hedges. An entity that does not elect to adjust the amount recorded in AOCI as a result of the discounting transition should ensure that this amount is reclassified into earnings when the hedged transaction affects earnings or when it is probable that the hedged transaction will no longer occur.

In fair value hedging relationships for which the shortcut method is used, a receipt or payment of a cash settlement (or equivalent) as a result of the discounting transition may also cause a mismatch in the cumulative change in fair value of the hedging instrument (e.g., an interest rate swap) and the cumulative-basis adjustments applied to the hedged item (e.g., fixed-rate debt hedged for changes in fair value because of changes in LIBOR). That is, the cumulative-basis adjustments will not be naturally unwound as settlements occur on the hedging instrument. ASU 2021-01 addresses this issue by adding an optional expedient that permits an entity to use a reasonable approach to adjust the cumulative-basis adjustment for the amount equal to the fair value change in the hedging instrument (i.e., a cash settlement or equivalent) as a result of the discounting transition. An entity could also elect, as an optional expedient, to continue to apply the shortcut method when assessing the effectiveness of the hedging relationship affected by the discounting transition.

ASC 848-30-25-9 currently provides that an entity may combine two or more derivative instruments, or proportions of those instruments, to be jointly designated as the hedging instrument in a hedging relationship without dedesignating the hedging relationship in response to reference rate reform. ASU 2021-01 adds a provision to ASC 848-30-25-9(b) that allows an entity to subsequently remove one or more, or proportions of, those derivatives without dedesignating the hedging relationship. Further, the ASU adds that an entity that applies any of the expedients in ASC 848 that allow an entity to assume perfect effectiveness may disregard any condition that prohibits more than one derivative from being designated as the hedging instrument.

In net investment hedging relationships involving receive-variable-rate, pay-variable-rate cross-currency interest rate swaps that reference a rate within the scope of ASC 848-10-15-3, 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 that case, an entity may also disregard the condition in ASC 815-20-25-67(a)(2) that both legs of the swap have the same repricing intervals and dates until (1) neither of the variable legs of the cross-currency interest rate swap designated references a rate within the scope of ASC 848-10-15-3 or (2) the guidance in ASC 848 is no longer applicable (e.g., when the provisions sunset).

Connecting the Dots

The optional expedient allowing the terms of a receive-variable-rate, pay-variable-rate cross-currency interest rate swap that is the designated hedging instrument in a net investment hedge to be modified as a result of reference rate reform without requiring a dedesignation of the hedging relationship is not directly related to the discounting transition. However, the FASB decided to amend ASC 848 to clarify its intent regarding the impact of reference rate reform on such derivatives on the basis of feedback received from constituents since the issuance of ASU 2020-04.[5]

Fair Value Hedges (ASC 848-40)

ASU 2021-01 provides that if a designated derivative is affected by the discounting transition, an entity is allowed to change the designated benchmark interest rate and the component of cash flows designated as the hedged item in a fair value hedging relationship without dedesignating the hedging relationship.

As discussed above, the ASU allows an entity to continue to apply the shortcut method when subsequently assessing effectiveness of a fair value hedging relationship affected by the discounting transition. This optional expedient will be available until the remainder of the original hedging relationship that includes periods after December 31, 2022. However, if an entity also elects the expedient that permits it to add one or more, or proportions of, derivatives to an existing hedging relationship for which the shortcut method is applied, the entity cannot continue to apply the shortcut method after December 31, 2022. That is,

[5] FASB Accounting Standards Update No. 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*.

the entity must cease the application of the shortcut method after December 31, 2022, and change to another effectiveness assessment method in ASC 815-20 and ASC 815-25.

Connecting the Dots

The election to apply any of the expedients discussed would not result in dedesignation of the existing fair value hedging relationship, but the entity would be required to update the hedge documentation to identify the elections.

Cash Flow Hedges (ASC 848-50)

If a derivative that is affected by the discounting transition is already designated in a cash flow hedging relationship using a hedge effectiveness assessment method under which perfect effectiveness was assumed, ASU 2021-01 allows an entity to continue to do either of the following:

- Apply the corresponding optional expedient to assume perfect effectiveness in accordance with the expedients previously provided by ASU 2020-04.
- Change its effectiveness approach to a quantitative method in accordance with ASC 815-20 and 815-30.

Regardless of which alternative it selects, an entity can make its election without dedesignating the hedging relationship.

In addition, ASU 2021-01 amends ASC 848-50-25-3 to allow an entity to change the designated benchmark interest rate for any cash flow hedging relationship involving the forecasted issuance or purchase of a fixed-rate debt instrument in which (1) the designated hedged risk is variability in cash flows attributable to changes in the benchmark rate and (2) the hedging instrument is affected by reference rate reform in accordance with ASC 848-10-15-3 (i.e., the hedging instrument references LIBOR or a reference rate that is expected to be discontinued as a result of reference rate reform).

Effective Date and Transition

The amendments in ASU 2021-01 are effective for all entities as follows:

Type	Effective Date and Expiration Date
Contract modifications	Entities should use either of the following approaches to apply the amendments to modifications to the terms of the derivatives affected by the discounting transition: • Retrospective as of any date from the beginning of an interim period that includes March 12, 2020. • Prospective from any date within an interim period that includes or is after January 7, 2021, up to the date that the financial statements are available to be issued.
Hedging relationships[6]	Entities should apply the amendments to either of the following types of eligible hedging relationships affected by the discounting transition: • Those existing as of the beginning of the interim period that includes March 12, 2020. • Those entered into after the beginning of the interim period that includes March 12, 2020.

[6] Under the ASU, if an entity adopts any of the amendments related to a hedging relationship and the entity is either (1) a private company that is not a financial institution as described in ASC 942-320-50-1 or (2) a not-for-profit entity (other than a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market), the entity is required to update its hedge documentation before the next interim (if applicable) or annual financial statements are available to be issued. All other entities that adopt any such amendments are required to update their hedge documentation no later than when those entities perform the first quarterly hedge effectiveness assessment after making any elections in the ASU for that hedging relationship.

The amendments do not apply to (1) contract modifications made or new hedging relationships entered into after December 31, 2022, or (2) existing hedging relationships evaluated for periods after December 31, 2022, unless an entity elects to apply certain optional expedients that permit the accounting effects to be retained through the end of the hedging relationships that extend beyond December 31, 2022. Under those optional expedients, an entity would:

- Use a reasonable approach to modify the fair value hedge basis adjustment in a fair value hedge accounted for under the shortcut method.
- No longer periodically evaluate the conditions in ASC 815-20-25-104(d) and (g) when using the shortcut method for a fair value hedge. However, the entity's application of the shortcut method would cease after December 31, 2022, if the entity elects the optional expedient to add one or more, or a proportion of, basis swaps to a fair value hedging relationship as a result of the discounting transition.
- Use a reasonable approach to adjust the amount recorded in AOCI for a cash flow hedge affected by a receipt or payment of a cash settlement (or equivalent) as a result of the discounting transition.
- Continue to use a subsequent assessment method under which perfect effectiveness is assumed in accordance with ASC 848-50-35-4 through 35-9 for a cash flow hedge if the entity elected the practical expedient that permits it to use a reasonable approach to adjust the amount recorded in AOCI as a result of the discounting transition.

Connecting the Dots

Under the ASU, any private company that has not yet adopted ASU 2017-12[7] is only allowed to elect the expedient permitting it to change the method designated for use in assessing the effectiveness of a hedging relationship if it elects the optional expedient under which it may apply "the simplified hedge accounting approach for eligible private companies for subsequent hedge effectiveness in paragraph 848-50-35-7" after the discounting transition.

[7] FASB Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*.

Appendix — Provisions That Were Not Directly Amended but Can Be Applied to Derivatives Within the Scope of ASC 848-10-15-3A

The table below, which is reproduced from ASC 848-10-55-1 (added by ASU 2021-01), clarifies which optional expedients in ASC 848 may be applied to derivative instruments that do not reference LIBOR or a reference rate that is expected to be discontinued, but that are being modified as a result of the discounting transition.

Codification Subtopic	Provisions That Apply to Derivatives That Meet the Scope of Paragraph 848-10-15-3A
848-20	a. Option to apply certain expedients in the contract modification relief to derivative instruments that meet the scope of paragraph 848-10-15-3A (paragraph 848-20-15-2A). b. Option to apply contract modification relief if terms that do not change contractual cash flows are modified contemporaneously with the modification of the interest rate used for margining, discounting, or contract price alignment (paragraph 848-20-15-4). c. Option to elect contract modification relief for a change in the interest rate used for margining, discounting, or contract price alignment separately from other derivative instrument modifications (paragraphs 848-20-35-1 and 848-20-35-5). d. Option to not reassess a previous accounting determination (paragraph 848-20-35-4). e. Flowchart that summarizes how to navigate Subtopic 848-20 (paragraph 848-20-55-1). f. Implementation guidance that illustrates relief in paragraph 848-20-35-4, including relief from reassessing whether a modified derivative is a hybrid instrument and whether it includes a financing element (paragraph 848-20-55-2).
848-30	a. Option to apply the hedging relief on an individual hedge and individual expedient basis (paragraph 848-30-25-2). b. Option to not dedesignate a hedging relationship due to a change in a critical term (paragraph 848-30-25-3). c. Requirement to update hedge documentation for a change in a critical term (paragraph 848-30-25-4). d. Option to change the contractual terms of a hedging instrument, hedged item, or forecasted transaction and to not dedesignate a hedging relationship (paragraph 848-30-25-5). e. Option to change the contractual terms of a hedging instrument by entering into a fully offsetting derivative and contemporaneously entering into a new derivative with revised terms (paragraph 848-30-25-6). f. Guidance that a change in the interest rate used for margining, discounting, or contract price alignment for a derivative hedging instrument should not be considered a change to the critical terms of the hedging relationship (paragraph 848-30-25-7). g. Option to continue to apply a perfectly effective assessment method for a cash flow hedge by electing the corresponding optional expedient for subsequent assessments under that method (paragraph 848-30-25-11A). h. Option to adjust the cumulative fair value hedge basis adjustment and to continue to apply the shortcut method by electing the corresponding optional expedient for the application of the fair value hedge shortcut method for a fair value hedge under the shortcut method affected by a payment or receipt of a cash settlement (or equivalent) intended to compensate for a modification of the interest rate used for margining, discounting, or contract price alignment for the derivative hedging instrument (paragraph 848-30-25-11B). i. Option to adjust the recorded amount in accumulated other comprehensive income and to apply certain effectiveness assessment expedients for a cash flow hedge affected by a payment or receipt of a cash settlement (or equivalent) intended to compensate for a modification of the interest rate used for margining, discounting, or contract price alignment for the derivative hedging instrument (paragraph 848-30-25-11C). j. Option to change the systematic and rational amortization method for excluded components (paragraphs 848-30-25-12 through 25-13).

(Table continued)

Codification Subtopic	Provisions That Apply to Derivatives That Meet the Scope of Paragraph 848-10-15-3A
848-40	a. Requirement for an entity that elects to apply the optional expedients in Subtopic 848-40 to continue to apply all other requirements applicable to fair value hedges in Subtopics 815-20 and 815-25 (paragraph 848-40-15-1). b. Option to apply the fair value hedging relief on an individual hedge and individual expedient basis (paragraph 848-40-25-1). c. Option to change the designated benchmark interest rate in a fair value hedging relationship (paragraph 848-40-25-2). d. Requirement to update hedge documentation upon a change in the designated benchmark rate (paragraph 848-40-25-3). e. Requirements and expedients related to continuing fair value hedge accounting without dedesignation if an entity elects to change the designated benchmark interest rate (paragraphs 848-40-25-4 through 25-7). f. Option to apply the subsequent effectiveness assessment expedient for the shortcut method if an entity was applying the shortcut method under Subtopics 815-20 and 815-25 before the modification of the interest rate used for margining, discounting, or contract price alignment and the requirement to update hedge documentation if elected (paragraphs 848-40-25-8 through 25-9).
848-50	a. Requirement for an entity that elects to apply the optional expedients in Subtopic 848-50 to continue to apply all other requirements applicable to cash flow hedges in Subtopics 815-20 and 815-30 (paragraph 848-50-15-1). b. Option to apply the cash flow hedging relief on an individual hedge and individual expedient basis (paragraph 848-50-25-1). c. Option to apply certain expedients for the application of subsequent assessment methods for cash flow hedges in which the hedging instrument meets the scope of paragraph 848-10-15-3A (paragraph 848-50-35-1). d. Option to apply the expedients in Subtopic 848-50 prospectively and the requirement to update hedge documentation if electing an optional expedient in Subtopic 848-50 (paragraphs 848-50-35-2 through 35-3). e. Option to apply a subsequent effectiveness assessment method that assumes perfect effectiveness if an entity was applying the corresponding perfectly effective method under Subtopics 815-20 and 815-30 before the modification of the interest rate used for margining, discounting, or contract price alignment (paragraphs 848-50-35-4 through 35-9). f. Requirement to cease applying subsequent assessment methods for assuming perfect effectiveness for cash flow hedges (paragraph 848-50-35-19A). g. Guidance on assessing hedge effectiveness and the subsequent accounting when optional expedient methods in paragraphs 848-50-35-4 through 35-9 are discontinued (paragraphs 848-50-35-20 through 35-21 and 848-50-35-23 through 35-24).

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