www.pwc.com

Reference rate reform

December 2022

pwc

About the Reference rate reform guide

PwC is pleased to offer our updated *Reference rate reform* guide. Reference rate reform is the term used to refer to the efforts that have been undertaken by regulators and other market participants to introduce new reference rates that are based on a larger and more liquid population of observable transactions. This guide is intended to assist our clients and other interested parties in applying the accounting and financial reporting guidance in ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*, ASU 2021-01, *Reference Rate Reform (Topic 848): Scope*, and ASU 2022-06, *Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848*.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification), and should be read in conjunction with the applicable authoritative accounting literature.

References to US GAAP

Definitions, full paragraphs, and excerpts from the FASB's Accounting Standards Codification are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other PwC guidance

This guide provides general and specific references to our *Derivatives and hedging* guide. References to this guide are indicated by DH followed by the specific section number (e.g., DH 9.6).

Summary of significant changes

The following is a summary of recent noteworthy revisions to the guide. Additional updates may be made to future versions to keep pace with significant developments.

Revisions made in December 2022

- Chapters REF 1, REF 2, REF 3, and REF 4 of this guide were updated to reflect the issuance of ASU 2022-06, which deferred the sunset date of ASC 848 from December 31, 2022 to December 31, 2024.

Revisions made in July 2022

REF 1: *Reference rate reform*

- REF 1.1 and REF 1.2 were updated to mention the recent exposure draft issued by the FASB that proposed extending the sunset date of ASC 848 and amending the definition of the SOFR swap rate used as a benchmark interest rate.

- Question REF 1-3 was added to address a situation when a contract is modified after previously being modified to replace USD LIBOR with SOFR.

REF 3: *Hedge accounting relief*

- Example REF 3-1 and Example REF 3-2 were added to illustrate how to apply the optional relief in ASC 848 to fair value hedges.
- REF 3.3.2 was added to address the relief offered under ASC 848 to change the forecasted transaction
- Example REF 3-3, Example REF 3-4, and Example REF 3-5 were added to illustrate how to apply the optional relief in ASC 848 to cash flow hedges.
- Example REF 3-6, Example REF 3-7, Example REF 3-8 and Example REF 3-9 were added to illustrate how to apply the optional relief in ASC 848 to changes in the forecasted transaction and the impact to amounts accumulated in other comprehensive income.
- Question REF 3-1 was added to address how a reporting entity should construct the hypothetical derivative when exiting the ASC 848 relief.

Copyrights

Table of contents

Chapter 1: Reference rate reform

1.1 Overview of reference rate reform

To compensate counterparties for the time value of money, many contracts reference interest rate indices (reference rates). For example, a debt instrument may have a coupon that periodically resets based upon the then-current reference rate. The London Interbank Offered Rate (LIBOR) has been one of the most commonly used reference rates in the global financial markets. In July 2017, the United Kingdom's Financial Conduct Authority announced that it would no longer persuade or compel banks to submit LIBOR as of the end of 2021. In early 2021, the ICE Benchmark Administration (the administrator for LIBOR) finalized its decision to cease the publication of the one week and two month US dollar (USD) LIBOR settings as well as all non-USD LIBOR settings immediately following the LIBOR publication on December 31, 2021, and the remaining USD LIBOR settings immediately following the LIBOR publication on June 30, 2023. Concerns about the sustainability of LIBOR and other interbank offered rates (IBORs) globally has led to an effort to identify alternative reference rates, as it is currently expected that non-USD LIBOR settings will cease to exist beyond 2021 while USD LIBOR settings are expected to cease to exist beyond June 2023. In the United States, the Alternative Reference Rates Committee (ARRC) convened by the Federal Reserve identified the Secured Overnight Financing Rate (SOFR) as its preferred alternative reference rate to US dollar LIBOR.

The shift away from the most widely used interest rate benchmarks to alternative reference rates is a significant change for the global financial markets. The impact of this change is not limited to financial services companies; it will impact all companies. IBOR rates are frequently used in financial instruments, such as debt agreements, investments, and derivatives, but may also be present in leases, compensation arrangements, and contracts with customers. Preparing for the impact of IBOR reform is likely to be a significant effort and will require a multidisciplinary team to identity where IBOR is used and negotiate changes to arrangements. Many institutions are already working to insert provisions frequently referred to as "fallback language" into new or existing agreements. These provisions specify how a replacement rate will be identified (and other terms, such as how the spread above the reference rate will be changed) once a trigger event (such as LIBOR no longer being quoted) occurs. Industry working groups continue to develop standard fallback terms for a number of financial instruments that they are recommending entities adopt.

From an accounting perspective, IBOR reform has the potential to create challenges when accounting for contract modifications and hedging relationships. For example, there may be a significant volume of contracts that will need to be modified and then assessed to determine whether the modification results in the establishment of a new contract or a continuation of the existing contract for accounting purposes. In addition, modifications related to reference rate reform to derivatives or hedged items involved in hedging relationships could result in de-designations of otherwise highly effective hedges.

As a result, on March 12, 2020, the FASB issued ASU 2020-04, *Reference Rate Reform (Topic 848), Facilitation of the Effects of Reference Rate Reform on Financial Reporting* (the "ASU"). This ASU, which introduces ASC 848 to the Codification, provides relief that, if elected, will require less accounting analysis and less accounting recognition for modifications related to reference rate reform. The ASU provides specific guidance relating to instruments subject to ASC 310, *Receivables*, ASC 470, *Debt*, ASC 840 or ASC 842, *Leases*, and ASC 815, *Derivatives and Hedging*. It also includes a principle that provides relief from contract modification requirements in other guidance not explicitly addressed.

A number of reporting entities are looking to amend agreements in preparation for reference rate reform in the short-term. As a result, the guidance was effective for all reporting entities immediately upon issuance on March 12, 2020, and a reporting entity could have elected to apply the optional expedients in the guidance from the beginning of the interim period that includes the effective date upon issuance. However, a reporting entity is not required to adopt the guidance upon issuance and can elect to apply the optional expedients prospectively in a reporting period subsequent to March 12, 2020. The relief is designed to be temporary, and as a result, this guidance cannot be applied subsequent to December 31, 2024, except for certain optional expedients elected for hedging relationships (see REF 4.1.4 for additional information).

In January 2021, the FASB issued ASU 2021-01, *Reference Rate Reform (Topic 848): Scope*, to clarify the scope of ASC 848 to include derivatives that are affected by a change in the interest rate used for margining, discounting, or contract price alignment that do not also reference LIBOR or another reference rate that is expected to be discontinued as a result of reference rate reform. Similar to ASU 2020-04, the guidance is effective for all reporting entities immediately upon issuance on January 7, 2021. A reporting entity may elect to apply the guidance retrospectively as of any date from the beginning of an interim period that includes or is subsequent to March 12, 2020, or prospectively to any new modifications within an interim period including or subsequent to January 7, 2021 (see REF 4.1.1 and REF 4.1.2 for additional information).

1.2 Optional election of ASC 848

ASC 848 offers optional relief that reporting entities can elect to account for qualifying contract modifications and hedge accounting relationships.

1.2.1 Contract modifications

ASC 848-20-35-1 discusses how the election of the contract modifications guidance is applied.

ASC 848-20-35-1

An entity may elect to apply the guidance in this Subtopic to account for contract modifications that meet the scope of paragraphs 848-20-15-2 through 15-3. If an entity elects to apply the guidance in this Subtopic, the entity shall apply it for all contract modifications that meet the scope of paragraphs 848-20-15-2 through 15-3 that otherwise would be accounted for in accordance with the same Topic or Industry Subtopic with the exception of derivative instruments that change the interest rate used for margining, discounting, or contract price alignment. The election to apply the guidance in this Subtopic to account for the modification of the interest rate used for margining, discounting, or contract price alignment for derivative instruments is separate from the election to apply the guidance in this Subtopic to account for other derivative instrument modifications. For example:

a. If an entity applies the guidance in this Subtopic to modifications of a lease for a lessee accounted for in accordance with Topic 842, it shall apply the guidance in this Subtopic to all modifications of leases accounted for in accordance with Topic 842 that meet the scope of paragraphs 848-20-15-2 through 15-3.

b. If an insurance entity applies the guidance in this Subtopic to modifications of a contract accounted for in accordance with Topic 310 on receivables, it shall apply the guidance in this Subtopic to all modifications of contracts accounted for in accordance with Industry Subtopic 944-310 that meet the scope of paragraphs 848-20-15-2 through 15-3. The entity does not need to apply the guidance in this Subtopic to contracts within the scope of other Industry Subtopics of Topic 944 that meet the scope of paragraphs 848-20-15-2 through 15-3.

c. If an entity applies the guidance in this Subtopic to modifications of an interest rate used for margining, discounting, or contract price alignment for derivative contracts as of July 1 2020, it shall apply the guidance in this Subtopic to all modifications of an interest rate used for margining, discounting, or contract price alignment for derivative instruments on and after July 1, 2020. The entity is not required to apply the guidance in this Subtopic to other modifications of derivative instruments (for example, changes in the reference rate index) as of July 1, 2020. For example, the entity may elect to apply the guidance in this subtopic to other derivative instrument modifications as of January 1, 2021. Alternatively, the entity may elect not to apply the guidance in this Subtopic to other derivative instrument modifications at any date.

The application of the guidance is elective, but if made, the election must be made for all contract modifications that:

- meet the scope of ASC 848 and
- would otherwise be accounted for in accordance with the same ASC Topic or Industry Subtopic (except for those derivatives modified to change the interest rates used for margining, discounting, or contract price alignment, as those changes are subject to a separate election as noted in ASC 848-20-35-1 above).

The guidance is intended to preclude a reporting entity from selectively applying the contract modification relief in ASC 848-20 on a contract-by-contract basis. For example, if a reporting entity elects to apply this guidance to the modification of a lease accounted for under ASC 842, the reporting entity must apply this guidance to all modifications of leases accounted for under ASC 842 that meet the scope of ASC 848. However, as discussed in more detail in REF 1.2.2, certain optional expedients related to the application of hedge accounting can be applied on a hedge-by-hedge basis.

Question REF 1-1

If a lessee elects to apply the guidance in ASC 848-20 to lease contract modifications, is the reporting entity required to apply the guidance in ASC 848-20 contract modifications of leases where the reporting entity is a lessor?

PwC response

Yes. If a reporting entity elects to apply the guidance in ASC 848-20 to modifications of a lease that would otherwise have to apply the lessee guidance in ASC 842-20, the reporting entity must apply the guidance in ASC 848-20 to all contract modifications that would otherwise have to apply the guidance in ASC 842, including leases where the reporting entity is the lessor in ASC 842-30.

Question REF 1-2

If a reporting entity elects to apply the guidance in ASC 848-20 to contract modifications of debt securities, is the reporting entity also required to apply the guidance in ASC 848-20 to contract modifications of other receivables (such as loans) within the scope of ASC 310?

PwC response

Yes. The refinancing and restructurings guidance in ASC 310-20 is applied to loans and debt securities. If a reporting entity elects to apply the guidance in ASC 848-20 to contract modifications of debt securities that would otherwise have to apply the guidance in ASC 310-20, the reporting entity must apply the guidance in ASC 848-20 to all contract modifications that would otherwise have to apply the guidance in ASC 310.

1.2.2 Hedge accounting

Unlike the guidance for contract modifications under ASC 848-20, a reporting entity can apply the optional expedients under ASC 848-30, ASC 848-40 and ASC 848-50 to hedge accounting relationships designated under ASC 815 on an individual hedging relationship basis. That is, an optional expedient can be elected for some hedging relationships but not elected for other similar hedging relationships. In addition, a reporting entity may elect to apply multiple optional expedients to the same individual hedging relationship and may elect those optional expedients in different reporting periods.

ASC 848-30-25-2

An entity may elect to apply the guidance in this Subtopic for hedging relationships affected by reference rate reform on an individual hedging relationship basis. In addition, an entity may elect to apply the different optional expedients specified in paragraphs 848-30-25-3 through 25-13 on an individual hedging relationship basis. That is, each optional expedient may be elected for each individual hedging relationship and may not be elected for other similar hedging relationships. In addition, an entity may elect multiple optional expedients for the same individual hedging relationship and may elect those optional expedients in different reporting periods. For example, for a cash flow hedge, an entity may elect the optional expedient for the changes in the critical terms of the hedging instrument in accordance with paragraphs 848-30-25-5 through 25-7 when the fallback protocol of the hedging instrument is changed. In a different reporting period, the entity may elect to apply the optional expedient in paragraph 848-30-25-8 to change the method used in assessing hedge effectiveness and may elect to apply an optional expedient for subsequent assessments of effectiveness set forth in Subtopic 848-50.

ASC 848-40-25-1

An entity may elect to apply the guidance in this Subtopic for fair value hedges affected by reference rate reform on an individual hedging relationship basis. In addition, an entity may elect to apply the different optional expedients specified in paragraphs 848-40-25-2 through 25-9 on an individual hedging relationship basis. For example, an entity may elect to apply the optional expedient in this Subtopic for the change in the designated benchmark interest rate and not elect to apply the optional expedient for the shortcut method for assessing hedge effectiveness.

ASC 848-50-25-1

An entity may elect to apply the optional expedients for the assessment of hedge effectiveness in this Subtopic to cash flow hedges affected by reference rate reform on an individual hedging relationship basis. In addition, an entity may elect to apply the different optional expedients for the assessment of hedge effectiveness in this Subtopic on an individual hedging relationship basis. An entity may disregard the guidance in paragraph 815-20-25-81 when applying the guidance in this Subtopic and shall not be required to assess effectiveness for similar hedges in a similar manner.

1.3 Scope of ASC 848

In order to qualify for the guidance in ASC 848, ASC 848-10-15-3 states that a contract must reference LIBOR (any maturity, jurisdiction, or currency) or a reference rate that is expected to be discontinued as a result of reference rate reform. Some indicators that a reference rate is expected to be discontinued are outlined in ASC 848-10-15-4. ASU 2021-01, *Reference Rate Reform (Topic 848): Scope*, clarified the scope of ASC 848 to include derivatives that use an interest rate for margining, discounting, or contract price alignment that is modified as a result of reference rate reform. This includes derivatives for which the interest rate being changed or the underlying variable rate is not LIBOR or is not a reference rate that is expected to be discontinued (see REF 1.3.1.3 for further information).

ASC 848-10-15-4

The guidance in this Topic applies to all maturities of LIBOR in all jurisdictions and currencies. For other reference rates, an expectation of the discontinuance of the rate may result from any of the following:

a. A public statement or publication of information by or on behalf of the administrator of the relevant reference rate or by the regulatory supervisor for the administrator

b. Initiatives by a significant number of market participants or by market participants representing a significant number of transactions to move away from the reference rate

c. The production method for the calculation of the published reference rate that is either:

   1. Fundamentally restructured

   2. Reliant on another rate that is expected to discontinue.

1.3.1 Qualifying modifications

With the exception of the optional expedients related to certain modifications of derivatives (see REF 1.3.1.3), the relief in ASC 848 applies to modifications of contracts that directly replace, or have the potential to replace, a reference rate that is expected to be discontinued. For example, if the contract is modified by replacing a reference to LIBOR with a reference to SOFR, this would be considered a direct replacement. Adding or modifying fallback language that would replace LIBOR with another reference rate upon a contingent event occurring is an example of a modification with the potential to replace a reference rate.

Only modifications to agreements that are made to affect the transition for reference rate reform will qualify for the guidance in ASC 848. If there are amendments to terms of the contract that change (or have the potential to change) the amount or timing of contractual cash flows that are unrelated to the replacement of the reference rate, the guidance in ASC 848 cannot be applied even if such amendments are made contemporaneous with amendments related to reference rate reform. If the modification does not qualify for the guidance in ASC 848, the modification (including any changes that are related to reference rate reform) should be assessed under other applicable guidance.

1.3.1.1 Modifications related to reference rate reform

Examples of modifications to terms generally considered to be related to the replacement of a reference rate, and therefore should qualify for the relief in ASC 848, are outlined in ASC 848-20-15-5.

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(a) 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.

1.3.1.2 Modifications unrelated to reference rate reform

Examples of modifications to terms that are generally considered to be unrelated to reference rate reform and therefore would not qualify for the relief in ASC 848 are outlined in ASC 848-20-15-6.

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.

ASC 848 presumes that contractual fallback terms added or amended such that they are consistent with or substantially similar to recommendations from a regulator or a private-sector working group convened by a regulator (such as the ARRC) are related to reference rate reform. This includes a predefined method to replace the current reference rate upon the discontinuance (or an expected discontinuance) of the reference rate.

Although ASC 848-20-15-6(c) lists changing to a fixed rate as a modification unrelated to reference rate reform, ASC 848-20-15-9 clarifies that adding a provision that the rate in a contract becomes fixed at the last published rate of an interest rate index would not preclude application of ASC 848.

In addition, ASC 848-20-15-8 provides that if a modification to a contract includes a fallback provision which includes a term that would generally be considered unrelated to reference rate reform (such as the addition of a prepayment option or a possibility that the rate could become fixed), such provisions would be disregarded if a reporting entity concludes at the time the fallback terms are added or amended that activation of that term is not probable of occurring if the fallback terms are triggered. This was included in the guidance as in some instances, fallback language may specify that the terms would change based on a "waterfall preference" established in the contract. For example, upon discontinuance of LIBOR, the reference rate would change to a term SOFR rate, however if a term SOFR rate was not available it would change to overnight SOFR, and if overnight SOFR was not available it would change based upon a sequenced list and in the event that it is unable to change to another reference rate, change to a fixed rate or permit prepayment as a "last resort." If this final change to a fixed rate is not probable of occurring at the time of amendment, the provision would not prevent application of ASC 848.

Question REF 1-3

If a contract has been modified to replace the reference rate within the contract from USD LIBOR to overnight SOFR, and the contract is subsequently modified through a separate modification to replace overnight SOFR with term SOFR, would the second contract modification qualify for the ASC 848 relief?

PwC response

No. ASC 848-20-15-2 states that the guidance within ASC 848 is applicable to contract modifications that replace or have the potential to replace a reference rate within the scope of ASC 848-10-15-3. In order to be within the scope of ASC 848-10-15-3, the rate being modified must be a reference rate expected to be discontinued as a result of reference rate reform (such as LIBOR). Therefore, once the contract has been modified to replace USD LIBOR with overnight SOFR, that contract no longer references a rate within the scope of ASC 848-10-15-3. Any subsequent modifications made to this contract would not qualify for the contract modification relief. The modification should be assessed under other applicable guidance.

Alternatively, at the time the initial contract modification was made when the contract still referenced USD LIBOR, a fallback protocol may be inserted into the contract that would allow the contract to "fallback" to overnight SOFR to the extent that a term SOFR market was not yet available and then pursuant to contractual terms that were included in this initial modification, change to term SOFR once available. In this case, the initial contract modification would qualify for the ASC 848 relief since the initial modification has the ability to replace a reference rate expected to be discontinued (USD LIBOR) by inserting fallback language. If the reference rate subsequently changes from overnight SOFR to term SOFR in line with the contractual provisions of the modified agreement, it is not considered a modification as it was triggered by existing contractual provisions.

1.3.1.3 Modifications related to the discounting transition

In order to support the transition away from interbank offered rates to alternative rates, the central clearing parties and (potentially) other market participants are undergoing various transitions to market conventions for interest rate derivatives. This includes changing the interest rates used for margining, discounting and contract price alignment ("the discounting transition"). The scope of the discounting transition is not limited to derivatives that have an underlying variable rate or an interest

rate used for margining, discounting or contract price alignment that references LIBOR or another reference rate that is anticipated to be discontinued. ASU 2021-01, *Reference Rate Reform (Topic 848): Scope*, added ASC 848-10-15-3A to clarify the scope of ASC 848 to include all derivatives that are modified due to the discounting transition.

ASC 848-10-15-3A

Certain provisions of the guidance in this Topic, if elected by an entity, shall apply to derivative instruments that do not meet the scope of paragraph 848-10-15-3 that use an interest rate for margining, discounting, or contract price alignment that is modified as a result of reference rate reform (see paragraph 848-10-55-1).

Chapter 2: Contract modifications relief

2.1 Contract modifications relief

ASC 848 includes optional expedients for qualifying modifications to financial assets under ASC 310, debt agreements under ASC 470, and leases under ASC 840 or ASC 842. ASC 848 also provides a principle that could be applied to contract modifications that fall within the scope of ASC 848 but are not explicitly specified in ASC 848 (e.g., contracts within the scope of ASC 606).

The optional expedients are meant to provide entities with the ability to conclude that qualifying contractual amendments should be treated as a modification or continuation of the existing contract without having to perform an assessment that would otherwise be required under GAAP.

2.1.1 Optional expedients: qualifying modifications

A reporting entity may elect to apply an optional expedient in accordance with ASC 848-20 to contract modifications that:

- replace, or have the potential to replace, LIBOR or another reference rate expected to be discontinued with a different interest rate index (e.g., replacing LIBOR with SOFR), and
- do not modify terms that change, or have the potential to change, the amount and timing of cash flows unrelated to the replacement of LIBOR or another reference rate expected to be discontinued (ASC 848-20-15-2 through ASC 848-20-15-3).

An election to apply an optional expedient under ASC 848-20 must be applied consistently to all eligible contract modifications subject to the same ASC Topic or Industry Subtopic (see REF 1.2.1).

In January 2021, the FASB issued ASU 2021-01, *Reference Rate Reform (Topic 848): Scope*, to clarify the scope of ASC 848 to include derivatives that use an interest rate for margining, discounting, or contract price alignment that is modified as a result of reference rate reform ("the discounting transition"). A reporting entity may elect to apply the optional expedient in ASC 848-20 for derivatives that are modified due to the discounting transition. This is not limited to derivatives that have a variable interest rate being changed that references LIBOR or another reference rate that is anticipated to be discontinued (see REF 1.3.1.3).

2.1.2 Optional expedient for financial assets under ASC 310

A reporting entity may elect to apply an optional expedient pursuant to ASC 848-20-35-6 to qualifying modifications (see REF 2.1.1) of contracts within the scope of ASC 310. Under the expedient, a reporting entity will account for modifications as if they were a minor modification in accordance with ASC 310-20 and thus a continuation of the existing contract. As a result:

- the amortized cost basis will consist of the remaining amortized cost basis in the original loan (which includes any unamortized net fees or costs from the original loan), and any additional fees received and direct loan origination costs associated with the restructuring,
- a new effective yield is established based upon the new amortized cost basis and the revised cash flows, and
- no gain or loss is recognized.

2.1.3 Optional expedient for debt agreements under ASC 470

A reporting entity may elect to apply an optional expedient pursuant to ASC 848-20-35-8 to qualifying modifications (see REF 2.1.1) of contracts within the scope of ASC 470. Under the expedient, a reporting entity will account for amendments as if the modification was not substantial in accordance with ASC 470-50 and thus a continuation of the existing contract. As a result:

- the new carrying amount will consist of the carrying amount of the original debt (which includes any unamortized fees from the original debt agreement and any unamortized premium or discount) and any additional fees between the debtor and creditor associated with the replacement or modified debt instrument,
- a new effective yield is established based upon the new carrying amount and the revised cash flows, and
- no gain or loss is recognized.

Third-party costs directly related to the exchange or modification (such as legal fees) are required to be expensed as incurred in accordance with ASC 470-50-40-18(b).

The debt modification and extinguishment guidance in ASC 470-50-40-12(f) requires a "lookback period" such that if within a year of the current debt modification or exchange, the debt has been exchanged or modified without being deemed to be substantially different, the debt terms that existed prior to the most recent modification or exchange are required to be used to determine whether the current exchange or modification is substantially different. However, once a debt modification or exchange accounted for under ASC 848 occurs, all prior debt modifications or exchanges will no longer be subject to the "lookback period." That is, ASC 848-20-35-10 requires any subsequent debt modification or exchange analysis to consider only the terms and provisions in effect immediately following the most recent modification or exchange under ASC 848.

2.1.4 Optional expedient for leases under ASC 840 or ASC 842

A reporting entity may elect to apply an optional expedient, pursuant to ASC 848-20-35-11 to qualifying modifications (see REF 2.1.1) of contracts within the scope of ASC 840 or ASC 842. Under the expedient, a reporting entity will not be required to:

- reassess lease classification,
- reassess the discount rate,
- remeasure lease payments, or
- perform other reassessments or remeasurements that would normally be required under ASC 840 or ASC 842 when a modification of the lease contract is not accounted for as a separate contract.

2.1.5 Principle in applying ASC 848 to other instruments

ASC 848-20 provides specific guidance for modifications of instruments subject to ASC 310, ASC 470, ASC 840, and ASC 842 as these topics cover instruments that will likely have the highest volume of contracts expected to be impacted by reference rate reform. However, ASC 848-20-35-3 through ASC

848-20-35-5 provide an optional election for instruments with modification guidance in other areas of GAAP not specifically addressed in ASC 848 if the contract modification qualifies under ASC 848-20 (see REF 2.1.1).

Under this principle, the modification should be treated as an event that does not require contract remeasurement at the modification or reassessment of a previous accounting determination under the relevant ASC Topic or Industry Subtopic. ASC 848-20-55-2 illustrates the potential outcomes in applying this expedient to contracts subject to guidance not specifically addressed in ASC 848.

2.1.5.1 Applying the principle to derivatives

A reporting entity may elect to apply the principle in ASC 848-20-35-4 to qualifying modifications (see REF 2.1.1) of derivatives within the scope of ASC 815. As described in ASC 848-20-55-2, a reporting entity that applies the optional expedient to qualifying contract modifications of derivatives will not be required to:

- reassess the derivative to determine if it is a hybrid instrument, or
- reassess whether the derivative includes a significant financing element in accordance with ASC 815-10-45-11 through ASC 815-10-45-15.

ASU 2021-01, *Reference Rate Reform (Topic 848): Scope*, clarifies that this guidance can also be applied to derivatives that use an interest rate for margining, discounting, or contract price alignment that is modified as a result of reference rate reform.

2.1.6 Reassessment of embedded derivatives

A reporting entity may elect to apply an optional expedient pursuant to ASC 848-20-35-14 to qualifying modifications (see REF 2.1.1) to not have to reassess embedded derivatives under ASC 815-15. Under the expedient, a reporting entity will not be required to reassess its original conclusions as to whether the contract contains an embedded derivative that is clearly and closely related to the host contract under ASC 815-15-25-1(a).

2.2 Reclassification or sale of held-to-maturity securities

A reporting entity may make a one-time election prior to December 31, 2024 to sell or reclassify (or both sell and reclassify) debt securities classified as held-to-maturity (HTM) to either available-for-sale (AFS) or trading pursuant to ASC 848-10-35-1. Under this guidance, the sale and/or reclassification, in and of itself, would not call into question the reporting entity's previous assertions that it had the intent and ability to hold the securities to maturity. Both of the following criteria, however, must be met at the date of transfer:

- The debt security references a rate that meets the scope of ASC 848-10-15-3 (i.e., a contract must reference LIBOR or a reference rate that is expected to be discontinued as a result of reference rate reform) and
- The debt security was classified as HTM before January 1, 2020.

For securities that are reclassified, the measurement guidance in ASC 320-10-35-10 through ASC 320-10-35-16 should be applied and recognized in the period the transfer occurs.

Question REF 2-1 addresses whether a reporting entity that makes the one-time election to sell HTM debt securities is able to subsequently sell other eligible HTM debt securities.

Question REF 2-1

As of March 15, 20X1, a reporting entity has identified eligible HTM debt securities that it intends to sell and apply the one-time election pursuant to ASC 848-10-35-1 on that date. However, the reporting entity is still in the process of evaluating whether it intends to sell or transfer other eligible HTM debt securities over the next several weeks. Can the reporting entity apply the one-time election pursuant to ASC 848-10-35-1 to those subsequent sales or transfers of eligible HTM debt securities?

PwC response

No. A reporting entity can only make its one-time election to sell or transfer (or to both sell and transfer) eligible HTM debt securities as of a specific date in the reporting period. A reporting entity cannot apply the one-time election to sell eligible HTM debt securities across multiple dates in a reporting period. If a reporting entity intends to sell eligible HTM debt securities over a period of time, it should make a one-time election to transfer the HTM debt securities to AFS or trading. Pursuant to ASC 848-10-35-2, a reporting entity shall recognize the transfer of eligible HTM debt securities to AFS or trading as of the date it makes its one-time election.

2.2.1 Required disclosures

If a reporting entity elects to sell and/or reclassify securities, the disclosure requirements in ASC 320-10-50-10 for a sale or transfer of securities classified as held-to-maturity apply. Such disclosures include:

- the net carrying amount of the HTM security that was sold or transferred,
- any derivative gains or losses deferred in accumulated other comprehensive income resulting from a hedge of the acquisition of the HTM security,
- the related unrealized or realized gain or loss, and
- the circumstances leading to the decision to sell or reclassify the HTM security.

Chapter 3: Hedge accounting relief

3.1 Hedge accounting relief

ASC 848 provides several optional expedients designed to allow hedging relationships to continue, without dedesignation, when one or more critical terms of the hedging relationship change, or are expected to change, due to reference rate reform. The type of relief that is available to reporting entities depends on a number of factors including the nature of the hedging relationship and the method in which effectiveness is assessed. Reporting entities should carefully evaluate whether their specific fact pattern enables them to qualify for relief in ASC 848 and the specific relief provisions that they are eligible to apply. Not all hedge relationships will qualify for the same relief provisions.

3.1.1 Scope of ASC 848: Hedging relationships

Optional expedients under ASC 848 may be applied if the hedging instrument, the hedged item, or the hedged forecasted transaction in a hedging relationship:

- references LIBOR or a reference rate expected to be discontinued (see ASC 848-10-15-3), and
- includes only modifications that are made or expected to be made related to the replacement of LIBOR or a reference rate expected to be discontinued (see ASC 848-20-15-2 through ASC 848-20-15-3).
    - This criterion is not required to elect the cash flow hedge optional expedient for assessing the probability of the hedged forecasted transaction (ASC 848-50-25-2), assessing a group of individual forecasted transactions (ASC 848-50-25-13 through ASC 848-50-25-14), assessing the initial assessment of hedge effectiveness performed using a quantitative method (ASC 848-50-25-11) and changing the method designated for assessing hedge effectiveness (ASC 848-30-25-8).

ASC 848-10-15-3

The guidance in this Topic, if elected by an entity, shall apply to contracts or other transactions that reference the London Interbank Offered Rate (LIBOR) or a reference rate that is expected to be discontinued as a result of reference rate reform.

ASC 848-10-15-3A

Certain provisions of the guidance in this Topic, if elected by an entity, shall apply to derivative instruments that do not meet the scope of paragraph 848-10-15-3 that use an interest rate for margining, discounting, or contract price alignment that is modified as a result of reference rate reform (see paragraph 848-10-55-1).

ASC 848-20-15-2

The guidance in this Subtopic, if elected, shall apply to contracts that meet the scope of paragraph 848-10-15-3 if either or both of the following occur:

a. The terms that are modified directly replace, or have the potential to replace, a reference rate within the scope of paragraph 848-10-15-3 with another interest rate index. 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 guidance in this Subtopic shall apply only if those modifications are related to the replacement of a reference rate. For example, the addition of

contractual fallback terms or the amendment of existing contractual fallback terms related to the replacement of a reference rate that are contingent on one or more events occurring has the potential to change the amount or timing of contractual cash flows and the entity potentially would be eligible to apply the guidance in this Subtopic.

b. The interest rate used for margining, discounting, or contract price alignment is modified as a result of reference rate reform.

ASC 848-20-15-2A

Certain optional expedients in this Subtopic, if elected, shall apply to derivative instruments that meet the scope of paragraph 848-10-15-3A (see paragraph 848-10-55-1).

ASC 848-20-15-3

Other than a modification of the interest rate used for margining, discounting, or contract price alignment in accordance with paragraph 848-20-15-2(b), for contracts that meet the scope of paragraph 848-10-15-3, the guidance in this Subtopic shall not apply if a contract modification is made to a term that changes, or has the potential to change, the amount or timing of contractual cash flows and is unrelated to the replacement of a reference rate. That is, this Subtopic shall not apply if contract modifications are made contemporaneously to terms that are unrelated to the replacement of a reference rate.

Certain expedients may be applied for derivatives designated as hedging instruments that are modified to change an interest rate used for margining, discounting, or contract price alignment (see ASC 848-10-15-3A). ASC 848-10-55-1 lists out the specific optional expedients that can be applied to derivatives that meet the scope of ASC 848-10-15-3A. This includes:

- for all hedges:
  - the option to not dedesignate a hedge relationship due to a change in the critical terms of the hedging relationship because of an election of an optional expedient (see REF 3.1.3),
  - the option to change the contractual terms of a hedging instrument, including by entering into fully offsetting derivative and contemporaneously entering into a new derivative with revised terms without dedesignating the hedge relationship (see REF 3.1.3), and
  - the option to change the systematic and rational amortization method for excluded components (see REF 3.1.5).
- for fair value hedges:
  - the option to change the designated benchmark interest rate (see REF 3.2.1),
  - the option to adjust the basis adjustment for a fair value hedge applying the shortcut method by the payment or receipt of a cash settlement (or equivalent) intended to compensate for the change in interest rate (see REF 3.2.3), and

- the option to apply the subsequent effectiveness assessment expedients when the shortcut method was used prior to the modification of the interest rate used for margining, discounting, or contract price alignment (see REF 3.2.2).

- for cash flow hedges:
  - the option to adjust the amount in accumulated other comprehensive income for a cash flow hedge by the payment or receipt of a cash settlement (or equivalent) intended to compensate for the change in interest rate (see REF 3.3.7), and
  - the option to continue applying a perfectly effective assessment methodology for a cash flow hedge using the subsequent effectiveness optional expedients in ASC 848 provided a perfectly effective assessment methodology was used prior to the modification of the interest rate used for margining, discounting, of contract price alignment or the option to switch to using a quantitative method (see REF 3.3.5).

Unlike the guidance for contract modifications under ASC 848-20, a reporting entity can apply the optional expedients to hedge accounting relationships designated under ASC 815 on an individual hedging relationship basis. That is, an optional expedient can be elected for some hedging relationships but not elected for other similar hedging relationships. In addition, a reporting entity may elect to apply multiple optional expedients to the same individual hedging relationship and may elect those optional expedients in different reporting periods. For example, a reporting entity may elect to apply the optional expedient to change the critical terms of a hedging relationship in one period and then elect to apply the optional expedient to change the method used for assessing hedge effectiveness in a different reporting period. There is no requirement when electing optional expedients under ASC 848 to assess effectiveness for similar hedges in a similar manner.

3.1.2 Updating hedge documentation

ASC 848 requires a reporting entity to update its hedge documentation upon changing the critical terms of a hedging relationship due to the election of an optional expedient for a fair value, cash flow, or net investment hedging relationship (including the reporting entity changing its method of assessing hedge effectiveness for the hedging relationship). The hedge documentation needs to be updated, pursuant to ASC 848-30-25-4, no later than when the reporting entity is required to perform its first assessment of hedge effectiveness after electing the optional expedient.

ASC 848-30-25-4

If an entity elects the optional expedient in paragraph 848-30-25-3, the entity shall update its hedge documentation (as applicable) noting the changes made no later than when the entity performs its first assessment of effectiveness after the change was identified in accordance with paragraphs 815-20-25-3(b)(2)(iv)(02) and 815-20-25-3A.

3.1.3 Changing critical terms

For a hedging instrument, hedged item, or forecasted transaction designated in a fair value, cash flow, or net investment hedge, a reporting entity may elect an optional expedient to change the contractual terms of the hedging instrument or hedged item. If the modification (a) directly replaces or has the potential to replace a reference rate within the scope of ASC 848-10-15-3 with a different interest rate

index and (b) does not modify a term that changes, or has the potential to change, the amount and timing of cash flows unrelated to the replacement of a reference rate (ASC 848-20-15-2 through ASC 848-20-15-3), a reporting entity may elect an optional expedient such that the modification would not trigger an automatic de-designation of the hedging relationship when the contractual terms are modified. ASC 848-30-25-7 specifies that a change to the interest rate used for margining, discounting, or contract price alignment for a derivative used as hedging instrument is not considered a change to the critical terms of the hedging relationship that requires dedesignation.

ASC 848 clarifies that this optional expedient applies to modifications to derivatives designated as hedging instruments, including changes that are effectuated by (1) entering into a fully offsetting derivative contract to effectively cancel the original derivative contract, and (2) contemporaneously entering into a new derivative contract with the revised terms. In these situations, even though a reporting entity entered into a new derivative contract, the reporting entity may still view the series of transactions as a modification of the original derivative contract that would not require an automatic de-designation of the hedging relationship (see ASC 848-30-25-5 through ASC 848-30-25-7).

This guidance may also be applied to derivatives that meet the scope of ASC 848-10-15-3A (derivatives that do not meet the scope of ASC 848-10-15-3 but that use an interest rate for margining, discounting, or contract price alignment that is modified as a result of reference rate reform) when a change in critical terms occurs.

3.1.4 Rebalancing of hedging relationships

Transitioning away from a discontinued reference rate to a replacement rate may result in certain hedging relationships needing to be adjusted because of changes in the terms of hedging instruments and hedged items. This may be the case, for example, when a reporting entity needs to rebalance the hedge ratio for duration-weighted fair value hedges that transition to another eligible benchmark interest rate. Additionally, a reporting entity may need to change the designated hedging instrument, for example, by adding a new interest rate basis swap to an existing interest rate swap designated as the hedging instrument in a cash flow hedge.

ASC 848-30-25-9 provides an optional expedient that can be elected to rebalance a hedging relationship without triggering an automatic de-designation. This optional expedient can be elected if the hedging instrument, the hedged forecasted transaction, or the designated benchmark interest rate in a fair value hedge references LIBOR, or a reference rate expected to be discontinued, and the hedging relationship is expected to be impacted by reference rate reform. This expedient also allows a reporting entity to subsequently remove one or more derivatives added under ASC 848-30-25-9 without dedesignating the hedge relationship. Depending on how a reporting entity chooses to rebalance a hedge relationship under ASC 848-30-25-9, there may be different expedients allowed for how to subsequently assess effectiveness.

3.1.4.1 Fair value hedge rebalancing

For fair value hedge relationships, ASC 848-30-25-9(a) permits rebalancing of the hedging relationship by any of the following means (including any combination):

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

If a reporting entity elects to change the designated portion of the hedged item, the cumulative effect on the basis adjustment of the hedged item should be recognized in earnings in the same income statement line item as the earnings effect of the hedged item.

A reporting entity can also change its designated hedging instrument to combine two or more derivative instruments, or proportions of those instruments, to be jointly designated as the hedging instrument in a fair value hedging relationship (see ASC 848-30-25-9(b)). If a reporting entity elects this alternative, it is required to assess hedge effectiveness of the amended relationship using an existing method outlined in ASC 815-20 and ASC 815-25. However, the method selected to assess hedge effectiveness does not need to be the original method designated for use at hedge inception; a reporting entity can elect to select another method under ASC 815-20 and ASC 815-25. As described in ASC 848-30-25-10, a reporting entity may elect to apply the optional expedient for the shortcut method in ASC 848-40 if the reporting entity is applying the shortcut method in ASC 815-20 at the time of the rebalancing of the hedging relationship, including combining two or more derivatives. However, as discussed in ASC 848-40-25-8, a reporting entity using two or more derivatives as a hedging instrument that elected the optional expedient to continue to apply the shortcut method is not permitted to continue to use the shortcut method beyond the sunset date of ASC 848. In this situation, the reporting entity can elect to apply an alternative hedge effectiveness methodology under ASC 815 as of the sunset date without having to dedesignate the hedge relationship. Refer to REF 3.2.2 for the optional expedients available when applying the shortcut method.

3.1.4.2 Cash flow hedge rebalancing

Similar to fair value hedges, for cash flow hedge relationships, a reporting entity can change the designated hedging instrument by combining two or more derivatives, or proportions of those instruments, to be jointly designated as the hedging instrument (see ASC 848-30-25-11 through ASC 848-30-25-11A).

If a reporting entity elects this optional expedient for a derivative that is modifying an interest rate that is LIBOR or anticipated to be discontinued, it is required to assess hedge effectiveness of the amended relationship using:

- a method in accordance with ASC 815-20 and ASC 815-30,
- an optional expedient for assuming perfect effectiveness (see ASC 848-50-35-4 through ASC 848-50-35-9),
- an optional expedient for the subsequent qualitative method after an initial assessment using a quantitative method in accordance with ASC 848-50-35-10 through ASC 848-50-35-16, or
- a quantitative method optional expedient (see ASC 848-50-35-17 and ASC 848-50-35-18).

If a reporting entity elects this optional expedient for a derivative that is modifying an interest rate that is used for margining, discounting, or contract price alignment, it is required to assess hedge effectiveness of the amended relationship using:

- the same quantitative or qualitative assessment method the reporting entity was using prior to making this election in accordance with ASC 815-20 and ASC 815-30, or

- an optional expedient method that assumes perfect effectiveness in accordance with ASC 848-50-35-4 through ASC 848-50-35-9 or a quantitative method in accordance with ASC 815-20 and ASC 815-30 if the reporting entity is applying a subsequent assessment method that assumes perfect effectiveness in accordance with ASC 815-20 at the time of the election.

3.1.5 Accounting for excluded components

ASC 815 allows for certain components of a hedging instrument to be excluded from a hedging relationship and recognized in earnings using either a mark-to-market approach or a systematic and rational method (see DH 6.3.1.2). When a hedging instrument's contractual terms are changed to replace, for example, LIBOR with an alternative reference rate, that change may affect the value of the hedging instrument's component excluded from hedge effectiveness.

Under ASC 848-30-25-12, a reporting entity may elect to prospectively change its systematic and rational method used to recognize excluded components in earnings for fair value, cash flow, or net investment hedges if the changes to the contractual terms of a hedging instrument:

- directly replaces or has the potential to replace a reference rate within the scope of ASC 848-10-15-3 with a different interest rate index, and

- does not modify a term that changes, or has the potential to change, the amount and timing of cash flows unrelated to the replacement of a reference rate (see ASC 848-20-15-2 through ASC 848-20-15-3).

The amended systematic and rational method may be subsequently amended for subsequent changes in the hedging instrument's contractual terms that meet the scope of ASC 848-20-15-2 through ASC 848-20-15-3. That is, a reporting entity may elect to apply this optional expedient for each modification. If elected, the amended method must be applied for the remaining life of the hedging relationship, including periods subsequent to December 31, 2024.

If a change to the contractual term of the hedging instrument results in a change in the fair value of the excluded component, a reporting entity may elect to recognize the change in fair value currently in earnings pursuant to ASC 848-30-25-13. The recognition of the change in fair value should be reported in the same income statement line item used to present the effect of the hedged item.

ASC 848 does not, however, permit a reporting entity to change whether a component is excluded or not.

This guidance may also be applied to derivatives that meet the scope of ASC 848-10-15-3A (derivatives that do not meet the scope of ASC 848-10-15-3 but that use an interest rate for margining, discounting, or contract price alignment that is modified as a result of reference rate reform) when the derivative's contractual terms that are changed affect the value of the derivative's component excluded from hedge effectiveness.

3.1.6 Changes to repricing intervals and dates in net investment hedges

ASC 848 provides a reporting entity with an optional expedient when a receive-variable-rate, pay-variable-rate cross-currency swap that references LIBOR or another rate expected to be discontinued as a result of reference rate reform (see ASC 848-10-15-3) is designated as a hedging instrument in a net investment hedge. ASC 815-20-25-67(a)(2) stipulates that both legs of a cross currency swap

designated as a hedging instrument in a net investment hedge must have the same repricing intervals and dates. This optional expedient provides relief from that requirement if the index of either or both of the legs of the cross-currency swap references a rate that meets the scope of ASC 848-10-15-3 until such time that neither leg references LIBOR or another rate anticipated to be discontinued. If neither of the legs of a cross currency swap references a rate that meets the scope of ASC 848-10-15-3 (and thus the hedge relationship no longer qualifies for the ASC 848 relief), and the legs of the swaps do not have the same repricing intervals and dates, then hedge accounting must be discontinued.

3.2 Fair value hedges

ASC 848 provides guidance on specific optional expedients for fair value hedging relationships affected by reference rate reform. Entities can elect the different optional expedients on an individual hedging relationship basis.

3.2.1 Changing the designated benchmark interest rate

When the designated hedged risk is changes in fair value attributable to a benchmark interest rate (see DH 6.4.5.1), changing the designated benchmark interest rate may be desirable if (1) the referenced interest rate index of the hedging instrument changes or (2) a reporting entity rebalances an existing fair value hedge relationship by combining two or more hedging instruments that are jointly designated as the hedging instrument (e.g., adding a new interest rate basis swap to an existing interest rate swap). For example, if a LIBOR swap was designated as the hedging instrument in a fair value hedge and a reporting entity selected the LIBOR swap rate as its designated hedged interest rate risk, the change in fair value of the swap and the change in fair value of the hedged item based on a LIBOR swap rate would differ if the swap's variable rate changes to overnight SOFR. As a result, a reporting entity may need to change the designated benchmark interest rate from LIBOR to overnight SOFR. If one of those two changes in the hedging instruments occur, a reporting entity may elect to change the designated benchmark interest rate and the component of cash flows related to the benchmark interest rate and continue hedge accounting without de-designation if all the following criteria in ASC 848-40-25-2 are met:

- The designated benchmark interest rate being changed is LIBOR or a reference rate expected to be discontinued (see ASC 848-10-15-3) or a derivative in the scope of ASC 848-10-15-3A.
- The replacement designated benchmark interest rate is an eligible benchmark interest rate in accordance with ASC 815-20-25-6A.
- The hedging instrument is expected to be prospectively highly effective at achieving offsetting changes in fair value attributable to the revised hedged risk on the basis of the amended terms of the hedging relationship.

Upon electing this optional expedient, a reporting entity is required to revise the rate used to discount the cash flows associated with the hedged item to reflect the change in the designated benchmark interest rate. A reporting entity may include a spread adjustment to the revised benchmark interest rate used to discount the cash flows associated with the hedged item. In addition, a reporting entity is permitted to adjust the cash flows for the designated term of the hedged item. If the hedging relationship extends beyond December 31, 2024 (i.e., the ASC 848 sunset date), ASC 848-40-25-6 requires a reporting entity to continue to use the revised discount rate (including the spread

adjustment, if applicable) and any remaining revised cash flows over the life of the designated hedging relationship.

Changing the designated benchmark interest rate in a fair value hedge will, absent other changes to the calculation, change the cumulative basis adjustment to the hedged item. ASC 848 addresses this by providing two approaches in ASC 848-40-25-5:

- *Apply an approach that adjusts the cumulative basis of the hedged item attributable to changing from the originally designated benchmark interest rate to the replacement designated benchmark interest rate.*

  Under this approach, a reporting entity would be required to recognize the change to the hedged item's basis adjustment immediately in earnings within the same income statement line used to present the earnings effect of the hedged item.

- *Apply an approach that results in no basis adjustment to the hedged item (i.e., maintain the same cumulative basis adjustment that existed prior to electing the optional expedient).*

  To accomplish this, one approach may include solving for a spread to include as an adjustment to the discount rate (the newly designated benchmark interest rate) such that, at the date the designated interest rate is changed, the present value of cash flows equals the carrying amount including the cumulative basis adjustment that existed prior to electing the optional expedient. If a reporting entity includes a spread adjustment, the spread adjustment would remain constant throughout the life of the hedge (even if the hedge continues beyond December 31, 2024).

The guidance does not prescribe a specific method for applying the measurement approaches above. A reporting entity is required to use a method that is reasonable. However, a reporting entity is required by ASC 848-40-25-5 to use a similar method for similar hedges and to justify the use of different methods for similar hedges. Therefore, while a reporting entity can elect to change the benchmark interest rate designated on an individual hedging relationship basis, once this optional expedient is elected, the approach to recognize the cumulative effect of the change in the designated benchmark interest rate must be applied in a similar manner to similar hedges. For instance, a reporting entity cannot elect the optional expedient in one hedge relationship and apply an approach that results in an immediate adjustment to earnings, while electing the optional expedient on another similar hedge and apply an approach that results in no basis adjustment (or no immediate earnings impact).

3.2.2 Applying the shortcut method (fair value hedge)

ASC 848 provides an optional expedient that can be elected to disregard certain criteria when determining whether a fair value hedging relationship continues to qualify for the shortcut method (see DH 9.4). The shortcut method provides criteria that, when met, allows for an assumption of perfect effectiveness in a fair value hedge relationship with an interest rate swap. The optional expedient may be elected upon a change in the contractual term of the hedging instrument that:

- directly replaces or has the potential to replace a reference rate within the scope of ASC 848-10-15-3 with a different interest rate index, and

- does not modify a term that changes, or has the potential to change, the amount and timing of cash flows unrelated to the replacement of a reference rate (ASC 848-20-15-2 through ASC 848-20-15-3).

When a reporting entity changes an interest rate swap's contractual terms, it may elect to disregard the criteria in ASC 848-40-25-8 when determining whether its fair value hedging relationship can continue to apply the shortcut method.

Excerpt from ASC 848-40-25-8

For fair value hedges for which the shortcut method is applied in accordance with paragraphs 815-20-25-102 through 25-105, 815-20-25-107 through 25-109 and 815-20-25-111 through 25-117, the following conditions from paragraph 815-20-25-104 that apply to fair value hedges may be disregarded in determining whether the hedging relationship continues to qualify for the shortcut method upon a change in the contractual terms of the hedging instrument in accordance with paragraphs 848-30-25-5 through 25-7:

a. the formula for computing net settlements under the interest rate swap is the same for each net settlement in accordance with paragraph 815-20-25-104(d), and

b. the terms are typical of those instruments, and the terms do not invalidate the assumption of perfect effectiveness in accordance with paragraph 815-20-25-104(g).

This optional expedient survives throughout the life of the fair value hedging relationship, which may extend beyond December 31, 2024 (the ASC 848 sunset date) unless a reporting entity elects the practical expedient in accordance with ASC 848-30-25-10 to combine two or more derivatives as the hedging instrument in a hedging relationship and continues to apply the shortcut method. In this instance, the reporting entity must cease applying the shortcut method after December 31, 2024, and must revert to assessing hedge effectiveness using a method prescribed in ASC 815-20 and ASC 815-25.

This guidance may also be applied to derivatives that meet the scope of ASC 848-10-15-3A (derivatives that do not meet the scope of ASC 848-10-15-3 but that use an interest rate for margining, discounting, or contract price alignment that is modified as a result of reference rate reform) when the shortcut method was used to assess effectiveness prior to the modification of the interest rate.

Examples REF 3-1 and REF 3-2 illustrate how to apply the various optional expedients within ASC 848 for a fair value hedging relationship throughout the relief period.

EXAMPLE REF 3-1

Fair value hedge applying the ASC 848 relief

On January 1, 20X1, Company A issues a five-year fixed rate debt instrument with quarterly interest payments at a rate of 5%. Company A is exposed to changes in the fair value of the debt instrument due to changes in interest rates and wants to hedge the changes in fair value due to changes in the benchmark interest rate. Company A enters into a fixed-to-float interest rate swap with a maturity of five years where Company A will pay USD LIBOR plus 200 bps and receive a fixed rate of 5%. The interest rate swap also pays quarterly interest. Company A designates this swap as a hedging instrument to hedge the changes in fair value of the hedged item due to changes in the benchmark interest rate which is designated as USD LIBOR. Company A assesses effectiveness using a quantitative long-haul method.

In December 20X2, Company A modifies its interest rate swap to change the floating leg of the swap to overnight SOFR.

Should Company A dedesignate its hedge relationship or could it adopt provisions of ASC 848 to continue its hedge relationship?

Analysis

Certain provisions of ASC 848 are available to Company A to allow it to continue its hedge relationship.

Company A has changed the critical terms of the hedge relationship by changing the contractual terms of the hedging instrument (the interest rate swap). Under ASC 815, a change in the critical terms of a hedge relationship would require the hedge relationship to be dedesignated. However, ASC 848-30-25-3 provides an optional expedient that allows a reporting entity to change the critical terms of a hedge relationship and not dedesignate the hedge relationship if the only change in critical terms is due to reference rate reform. Since Company A changed the critical terms of the hedging instrument only to switch the floating leg of the interest rate swap from LIBOR to overnight SOFR, the modification is eligible for the relief under ASC 848. Company A would not be required to dedesignate the hedge relationship if it adopts the optional expedient in ASC 848-30-25-3. In accordance with ASC 848-30-25-4, Company A would need to update its hedge documentation for the change in critical terms by the time it performs its next assessment of effectiveness. Assuming Company A performs its effectiveness assessment at quarter end, it would need to update its hedge documentation for the change by December 31, 20X2.

Company A may also wish to change the designated benchmark interest rate within the hedge relationship from LIBOR to overnight SOFR. Similar to the change to the hedging instrument, this would normally be considered a change in critical terms of the hedging relationship that would require dedesignation. However, the relief in ASC 848-40-25-2 (if elected) would allow Company A to update the designated benchmark interest rate in the hedge relationship if (1) the designated benchmark interest rate being changed is LIBOR, (2) the replacement designated benchmark interest rate is an eligible rate in accordance with ASC 815-20-25-6A, and (3) the hedge relationship is expected to be highly effective prospectively. ASC 815-20-25-6A lists the Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate as a benchmark interest rate. Therefore, Company A designates the Overnight SOFR swap rate as the new benchmark interest rate being hedged which is consistent with the rate on the interest rate swap.

Once the optional expedient within ASC 848-40-25-2 has been elected, Company A would be required to revise the rate used to discount the cash flows associated with the hedged item to reflect the change in the designated benchmark interest rate. The update to the designated benchmark interest rate would change the calculation of the cumulative basis adjustment. ASC 848-40-25-5 provides two alternatives for how to account for the change to the calculation of the cumulative basis adjustment. A reporting entity may either calculate a new cumulative basis adjustment based on the updated discount rate used to discount the hedged item cash flows and record the change in the basis adjustment through earnings, or apply a spread adjustment to the calculation (such as by applying a spread to the discount rate used to discount the hedged item cash flows or adjusting the hedged item's cash flows) that would result in no change to the cumulative basis adjustment. If a spread adjustment is applied, this spread adjustment must be consistently applied for the remainder life of the hedge relationship. Company A should apply the method selected to similar hedges and must justify using a different methodology for similar hedges.

Once the hedge documentation has been updated, the hedge relationship no longer qualifies for the ASC 848 relief since the relationship no longer references a rate expected to be discontinued (though as noted, if Company A elected to apply a spread adjustment when updating the benchmark interest rate, this adjustment must be consistently applied for the entire life of the hedge relationship). Company A must now apply the requirements in ASC 815 to assess hedge effectiveness.

EXAMPLE REF 3-2

Fair value hedge applying the ASC 848 relief

Assume the same facts as Example REF 3-1 except that rather than modifying the interest rate swap directly, Company A enters into a basis swap that has the effect of swapping its USD LIBOR payments to overnight SOFR payments.

Could Company A elect to jointly designate the original USD LIBOR-based interest rate swap and the newly entered into basis swap as the hedging instrument without dedesignating the hedge relationship?

Analysis

Yes. ASC 848-30-25-9(b) notes that reporting entities can update the designated hedging instrument to combine two or more derivative instruments to jointly designate these derivatives as the hedging instrument. This would be considered a change in the critical terms of the hedge relationship; however, ASC 848-30-25-3 provides an optional expedient to allow a reporting entity to change the critical terms of a hedge relationship and not dedesignate the hedge relationship if the change in critical terms was solely due to reference rate reform. Therefore, Company A could jointly designate the USD LIBOR-based interest rate swap and the USD LIBOR to overnight SOFR basis swap as the hedging instrument and continue to apply hedge accounting.

3.2.3 Adjusting the basis adjustment under shortcut method

ASC 848-30-25-11B provides an optional expedient for a fair value hedge using the shortcut method to allow a reporting entity to adjust the fair value hedge basis adjustment for the amount of cash compensation paid or received related to the change in the interest rate used for margining, discounting, or contract price alignment using a reasonable approach. A reporting entity should use a similar method for similar hedges. If different approaches for similar hedges are used, the reporting entity must justify its rationale.

3.3 Cash flow hedges

ASC 848 provides a number of optional expedients for cash flow hedging relationships affected by reference rate reform, as well as guidance on assessing probability when the forecasted transaction will be affected by reference rate reform.

3.3.1 Probability of the forecasted transaction

In order to apply cash flow hedging, entities are required to document the forecasted transaction in a cash flow hedge and to support that the documented forecasted transaction remains probable of occurring throughout the life of the hedge relationship (see DH 6.3.3.4). Additionally, a change in the

probability of a forecasted transaction may require that a reporting entity discontinue hedge accounting and may affect the timing of recognizing amounts deferred in accumulated other comprehensive income in earnings. To alleviate stakeholder concerns over how meeting these requirements might be affected by reference rate reform, ASC 848 provides an optional expedient on how to evaluate probability when the forecasted transaction references LIBOR or another reference rate expected to be discontinued.

When the designated hedged risk in a cash flow hedge of a forecasted transaction is LIBOR, or another reference rate expected to be discontinued, ASC 848-50-25-2 allows a reporting entity to assert that the hedged forecasted transaction remains probable of occurring regardless of a modification or expected modification that:

- directly replaces or has the potential to replace a reference rate within the scope of ASC 848-10-15-3 with a different interest rate index, and
- does not modify a term that changes, or has the potential to change, the amount and timing of cash flows unrelated to the replacement of a reference rate (see ASC 848-20-15-2 through ASC 848-20-15-3).

That is, when a reporting entity modifies, or expects to modify, contractual terms that are related to the replacement of a reference rate in accordance with ASC 848, a reporting entity may continue to assert that the forecasted transaction (documented as the reference rate that will be replaced) continues to be probable of occurring (i.e., the hedge is not discontinued). The ability to continue to assess the forecasted transaction as probable of occurring applies when the change in contractual terms is expected to replace the reference rate (i.e., the rate designated in the cash flow hedge) with another reference rate. It would not, however, apply in circumstances when the underlying transaction (e.g., the forecasted interest payments) was probable of not occurring (e.g., a reporting entity expects to pay off its debt). This relief is limited to forecasted transactions involving LIBOR or another reference rate that is expected to be discontinued. Once a reporting entity has modified the hedged item or the hedge documentation such that the forecasted transaction no longer references LIBOR or another reference rate that is expected to be discontinued, the relief provided by ASC 848 relating to probability is no longer applicable.

3.3.2 Change in the forecasted transaction

ASC 848-30-25-5 permits a reporting entity, under certain circumstances, to change the forecasted transaction. For example, a reporting entity may be able to change a forecasted transaction from a hedge of quarterly three-month LIBOR payments to monthly payments based on overnight SOFR.

ASC 848-30-25-5

An entity may change the contractual terms of a hedging instrument, a hedged item, or a forecasted transaction designated in a fair value hedge, a cash flow hedge, or a net investment hedge that is affected or expected to be affected by reference rate reform and not be required to dedesignate the hedging relationship if the changes to the contractual terms meet the scope of paragraphs 848-20-15-2 through 15-3.

3.3.3 Change in the designated hedged risk

ASC 815-30-35-37A indicates that the designated hedged risk for a cash flow hedge of a forecasted transaction may change during a hedging relationship and a reporting entity may continue to apply hedge accounting if the hedge remains highly effective. ASC 848 expands how a reporting entity can evaluate whether a cash flow hedge relationship affected by reference rate reform remains highly effective. Specifically, upon a change in the designated hedge risk on a hedge impacted by reference rate reform (e.g., replacing LIBOR with SOFR), ASC 848 provides that an existing cash flow hedge relationship may continue hedge accounting subject to the hedging relationship remaining highly effective (ASC 848-50-25-3) based upon a reporting entity:

- assessing hedge effectiveness in accordance with ASC 815-20 and ASC 815-30, or
- electing an optional expedient method to assess hedge effectiveness in accordance with ASC 848-50.

3.3.3.1 Benchmark rate of a forecasted debt issuance or purchase

When hedging the forecasted issuance or purchase of fixed-rate debt, ASC 815-20-25-19A(a) and ASC 815-20-25-19B require that the reporting entity must designate the variability in cash flows attributable to changes in the benchmark interest rate as the hedged risk. ASC 848-50-25-3 states that if the hedging instrument references LIBOR or another rate expected to be discontinued due to reference rate reform (see ASC 848-10-15-3) and the referenced interest rate index changes (or a reporting entity changes the designated hedging instrument by combining two or more derivatives) in a hedge of a forecasted issuance or purchase of fixed rate debt, a reporting entity may change the benchmark interest rate being hedged as long as:

- the replacement designated benchmark interest rate is an eligible benchmark rate in accordance with ASC 815-20-25-6A, and
- the hedging relationship remains highly effective in accordance with ASC 815-20 or ASC 815-30.

If the reporting entity does not know at the inception of the hedging relationship whether the debt instrument that will be issued or purchased will be fixed rate or variable rate, this guidance also applies.

3.3.4 Hedging a group of forecasted transactions

When hedging a group of forecasted transactions, ASC 815-20-25-15(a)(2) requires that the individual transactions in the group share the same risk exposure. However, if the group of forecasted transactions references LIBOR or another reference rate expected to be discontinued due to reference rate reform, a reporting entity may elect to disregard that guidance based on the guidance in ASC 848-50-25-13 through ASC 848-50-25-14. However, the requirement prohibiting a forecasted purchase and a forecasted sale from both being included in a group continues to apply. As a result, forecasted interest receipts and forecasted interest payments are not permitted to be included in the same group, even if a reporting entity elects this optional relief.

3.3.5 Changing the designated method of assessing effectiveness

A reporting entity may elect to change the method designated for use in assessing hedge effectiveness in a cash flow hedge (ASC 848-50-35-1 through ASC 848-50-35-3) if both of the following criteria in ASC 848-30-25-8 are met:

- Either the hedging instrument or the hedged forecasted transaction (but not both) references LIBOR or a reference rate expected to be discontinued due to reference rate reform.
- The new designated method of assessing hedge effectiveness is an optional expedient specified in ASC 848-50 (see REF 3.3.6).

For a cash flow hedge with a hedging instrument that meets the scope of ASC 848-10-15-3A, a reporting entity that was previously using a subsequent effectiveness method that assumed perfect effectiveness at the time of the election of the optional expedient may (1) apply the corresponding available optional expedients for the subsequent assessment method for assuming perfect effectiveness in accordance with ASC 848-50-35-4 through ASC 848-50-35-9, or (2) switch to using a quantitative measure of assessing effectiveness in accordance with ASC 815-20 and ASC 815-30 after the election.

If a reporting entity applies this optional expedient and changes its method of assessing effectiveness, the replacement method is not required to be assessed to determine whether it is an improved method or if it is considered a preferable method.

Upon electing an optional expedient method, reporting entities are required to assess effectiveness using the newly designated method prospectively from the date in which the optional expedient method is elected to determine whether hedge accounting may continue to be applied. After the date on which the optional expedient is first applied (assuming the hedging relationship was highly effective), both retrospective and prospective hedge effectiveness need to be assessed using the optional expedient method.

3.3.6 Optional expedients—initial and subsequent hedge effectiveness

A reporting entity may perform its initial and subsequent hedge effectiveness assessment in a manner that adjusts how it applies certain guidance in ASC 815-20 and ASC 815-30 for cash flow hedges in which the hedged forecasted transaction or hedging instrument references LIBOR or a reference rate expected to be discontinued due to reference rate reform.

See REF 3.3.6.1 through REF 3.3.6.8 for the optional expedients for assessing initial and subsequent hedge effectiveness under ASC 848.

3.3.6.1 Applying the shortcut method (cash flow hedge)

ASC 815 provides a list of criteria that must be met in order to assume perfect hedge effectiveness in a cash flow hedge with an interest rate swap, which is referred to as the shortcut method (see DH 9.4). Under ASC 848, a reporting entity may elect to disregard the items in ASC 848-50-25-6 (and repeated in ASC 848-50-35-5 for subsequent assessments) when assessing whether the shortcut method can be applied. In order to be eligible for this expedient, the hedged forecasted transaction or hedging instrument must reference LIBOR or a reference rate expected to be discontinued due to reference rate reform.

Excerpt from ASC 848-50-25-6 and ASC 848-50-35-5

a. the formula for computing net settlements under the interest rate swap is the same for each net settlement in accordance with paragraph 815-20-25-104(d).

b. the terms are typical of those derivative instruments and do not invalidate the assumption of perfect effectiveness in accordance with paragraph 815-20-25-104(g).

c. the repricing dates of the variable-rate asset or variable-rate liability and the hedging instrument must occur on the same dates and be calculated the same way in accordance with paragraph 815-20-25-106(d).

d. the index on which the variable leg of the interest rate swap is based matches the contractually specified interest rate designated as the interest rate being hedged for that hedging relationship in accordance with paragraph 815-20-25-106(g).

3.3.6.2 Option's terminal value (assuming perfect effectiveness)

When hedge effectiveness is based on an option's terminal value, ASC 848 permits a reporting entity to disregard the criteria in ASC 848-50-25-7 (repeated in ASC 848-50-35-6 for subsequent assessments) when determining whether a hedging relationship is considered perfectly effective under ASC 815-20-25-126 through ASC 815-20-25-129A. In order to be eligible for this expedient, the hedged forecasted transaction or hedging instrument must reference LIBOR or a reference rate expected to be discontinued due to reference rate reform.

Excerpt from ASC 848-50-25-7 and ASC 848-50-35-6

a. The underlying of the hedging instrument needs to match the underlying of the hedged forecasted transaction in accordance with paragraph 815-20-25-129(a).

b. The strike price (or prices) of the hedging option (or combination of options) matches the specified level (or levels) beyond (or within) which the entity's exposure is being hedged in accordance with paragraph 815-20-25-129(b).

c. The hedging instrument's inflows (outflows) at its maturity date due to the underlying reference rate and strike price (or prices) of the hedging option (or combination of options) completely offset the change in the hedged transaction's cash flows for the risk being hedged in accordance with paragraph 815-20-25-129(c).

See DH 9.6 for further details on the terminal value method of assessing hedge effectiveness for options.

3.3.6.3 Option's terminal value (not considered perfectly effective)

When hedge effectiveness is based upon an option's terminal value but is not considered perfectly effective, a reporting entity may adjust the critical terms of the perfectly hypothetical hedging instrument in ASC 848-50-25-12 (repeated in ASC 848-50-35-18 for subsequent assessments) to match the hedging instrument. In order to be eligible for this expedient, the hedged forecasted

transaction or hedging instrument must reference LIBOR or a reference rate expected to be discontinued due to reference rate reform.

Excerpt from ASC 848-50-25-12 and ASC 848-50-35-18

a. The underlying reference rate

b. The strike price (or prices) of the hedging option (or combination of options)

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

In effect, the guidance permits a reporting entity to assume that certain attributes of the forecasted transaction are different than they may be for purposes of assessing hedge effectiveness.

3.3.6.4 Change-in-variable-cash-flows (assuming perfect effectiveness)

When applying the change-in-variable-cash-flows method in ASC 815, a reporting entity may disregard the terms in ASC 848-50-25-9 (repeated in ASC 848-50-35-8 for subsequent assessments) when assessing whether the hedge is perfectly effective in accordance with ASC 815-30-35-22. In order to be eligible for this expedient, the hedged forecasted transaction or hedging instrument must reference LIBOR or a reference rate expected to be discontinued due to reference rate reform.

Excerpt from ASC 848-50-25-9 and ASC 848-50-35-8

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

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

A reporting entity may also disregard the guidance in ASC 815-30-35-22(c), which addresses other potential basis differences (e.g., caps or floors) that would preclude a hedge from being perfectly effective, when applying ASC 848 if the basis differences are due to differences in a cap or floor between the variable-rate leg of the interest rate swap and the variable-rate asset or liability.

See REF 3.3.6.6 for the application of the change-in-variable-cash-flow method when the hedge is not considered perfectly effective.

3.3.6.5 Hypothetical derivative (assuming perfect effectiveness)

When applying the hypothetical derivative method in accordance with ASC 815-30-35-25 through ASC 815-30-35-29, a reporting entity may elect to disregard the critical terms detailed in ASC 848-50-25-10 (repeated in ASC 848-50-35-9 for subsequent assessments) when determining whether the hypothetical derivative will result in a perfectly effective hedge. In order to be eligible for this expedient, the hedged forecasted transaction or hedging instrument must reference LIBOR or a reference rate expected to be discontinued due to reference rate reform.

Excerpt from ASC 848-50-25-10 and ASC 848-50-35-9

a. The same repricing dates in accordance with paragraph 815-30-35-25(b)(2)

b. The same index in accordance with paragraph 815-30-35-25(b)(3)

c. Mirror image caps and floors (including a cap or floor that exists in a variable-rate asset or a variable-rate liability and does not exist in a hedging instrument or vice versa) in accordance with paragraph 815-30-35-25(b)(4).

See REF 3.3.6.6 for the application of the hypothetical derivative method when the hedge is not considered perfectly effective.

3.3.6.6 Applying a quantitative assessment method of effectiveness

When assessing hedge effectiveness quantitatively, a reporting entity may elect to make certain adjustments when applying the (1) change-in-variable-cash-flows method, (2) the hypothetical derivative method, or (3) the change-in-fair-value method. In applying these methods:

- If both the hedged forecasted transaction and the hedging instrument reference LIBOR or another reference rate expected to be discontinued due to reference rate reform (see ASC 848-10-15-3), a reporting entity may assume the reference rates will not change for the remainder of the hedging relationship. This might be applied in situations when neither the hedged item nor the hedging instrument have been amended as a result of reference rate reform.

- In a cash flow hedge of a forecasted purchase, sale, or issuance of a fixed-rate instrument, if (1) the designated hedged interest rate risk is the benchmark interest rate and (2) the hedging instrument has a reference rate that meets the scope of ASC 848-10-15-3, a reporting entity may assume the reference rates will not change for the remainder of the hedging relationship.

- If either the hedged forecasted transaction or the hedging instrument references LIBOR or another reference rate expected to be discontinued due to reference rate reform, the terms of the hedged forecasted transaction may be altered to match the hedging instrument for the terms detailed in ASC 848-50-25-11 (repeated in ASC 848-50-35-17).

Excerpt from ASC 848-50-25-11 and ASC 848-50-35-17

1. The referenced interest rate index,

2. The reset period, reset dates, day-count conventions, business-day conventions, and repricing calculation (for example, forward-looking calculation or in-arrears calculation), and

3. A spread adjustment for the difference between the existing reference rate and the replacement reference rate.

4. A cap or floor (including a cap or floor that exists in a variable-rate asset or a variable-rate liability and does not exist in a hedging instrument or vice versa).

This might be applied if, for example, the referenced rate of the hedging instrument has been replaced, but the referenced rate of the hedged item has not yet been modified.

3.3.6.7 Applying a qualitative assessment method of effectiveness

ASC 848 provides an optional expedient when qualitatively assessing whether a hedging relationship is highly effective in periods subsequent to initial designation (i.e., after the initial hedge effectiveness assessment is performed applying ASC 815-20, ASC 815-30, or an optional expedient under ASC 848). A reporting entity may elect to disregard the guidance in ASC 815-20-35-2A through ASC 815-20-35-2F when assessing whether a cash flow hedging relationship is highly effective on a qualitative basis.

Under the optional expedient in ASC 848-50-35-10, a reporting entity may continue to assert qualitatively that it may continue to apply hedge accounting if the following criteria in ASC 848-50-35-11 are met:

- The hedged forecasted transaction or the hedging instrument references a rate that meets the scope of ASC 848-10-15-3 (i.e., it references LIBOR or a reference rate that is expected to be discontinued as a result of reference rate reform).

- There have been no changes to the terms of the hedging instrument or the forecasted transaction other than those specified in ASC 848-20-15-2 through ASC 848-20-15-3 (i.e., the only modifications made are to directly replace or have the potential to replace a reference rate (see REF 1.3.1.1)).

- A reporting entity considers the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the reporting entity.

If a qualitative assessment of effectiveness is applied, the reporting entity should verify and document whenever financial statements (or earnings) are reported, and at least every three months, that the facts and circumstances have not changed and that these criteria continue to be met. If the facts and circumstances have not changed and these criteria continue to be met, a reporting entity may continue to qualitatively assert that the hedging relationship continues to qualify for hedge accounting.

If the facts and circumstances have changed such that these criteria are no longer met, the reporting entity can no longer assert qualitatively that the hedging relationship continues to qualify for hedge accounting, the reporting entity should perform an assessment of effectiveness on a quantitative basis in accordance with ASC 815-20, ASC 815-30, or a quantitative optional expedient within ASC 848 (if eligible). A reporting entity may apply a method other than the method designated for use and documented at hedge inception but must update its hedge documentation as discussed in ASC 848-30-25-4.

If the date of the change in facts and circumstances that led to the criteria no longer being met cannot be identified, the reporting entity may begin performing their quantitative assessment from the beginning of the current period. Once a reporting entity has performed a quantitative assessment using an optional expedient for at least one period, the reporting entity may revert to a qualitative optional expedient assessment under ASC 848-50 if they qualify to do so.

Examples REF 3-3, REF 3-4, and REF 3-5 illustrate how to apply the various optional expedients within ASC 848 for a cash flow hedging relationship throughout the relief period.

EXAMPLE REF 3-3

Cash flow hedge applying the ASC 848 relief

On January 1, 20X1, Company A issues a five-year floating rate debt instrument that pays quarterly interest payments at USD LIBOR with no additional spread. Company A wants to hedge the variability in interest payments of the debt instrument due to the contractually specified USD LIBOR rate. Company A enters into a fixed-to-float interest rate swap with a maturity of five years where Company A will receive USD LIBOR and pay a fixed rate of 3%. The interest rate swap also pays quarterly interest. Company A designates this swap as a hedging instrument to hedge the variability of the forecasted interest payments due to changes in the contractually specified rate, which is LIBOR. Company A uses the hypothetical derivative method to assess effectiveness and determines that the terms of the hypothetical derivative exactly match the terms of the actual hedging instrument. As a result, Company A applies the guidance in ASC 815-20-25-3(b)(2)(iv)(01)(F), and qualitatively assesses that the hedge relationship is perfectly effective.

On December 31, 20X1, Company A becomes aware that USD LIBOR will be discontinued on June 30, 20X3 and that the hedge relationship is expected to be affected by reference rate reform since the forecasted interest payments on the debt and the interest rate swap continue through January 1, 20X6. However, as of December 31, 20X1, Company A has not yet modified the debt instrument or the interest rate swap, so both instruments continue to reference LIBOR.

Could Company A continue hedge accounting for its cash flow hedge relationship without dedesignating?

Analysis

Yes, Company A may utilize optional expedients within ASC 848 to continue hedge accounting.

Company A must first determine whether it is within the scope of ASC 848. ASC 848-30-15-1 notes that the scope of reference rate reform relief includes hedge relationships if the hedging instrument, the hedged item, or the hedged forecasted transaction in that hedge relationship references a rate that meets the scope of ASC 848-10-15-3. ASC 848-10-15-3 specifically notes that LIBOR is a reference rate expected to be discontinued that is within its scope. Therefore, Company A would be eligible to apply certain aspects of the relief within ASC 848 to this hedge relationship.

One of the requirements to hedge forecasted transactions in ASC 815, such as forecasted interest payments on an existing liability, is that the reporting entity must be able to assert that the forecasted transactions remain probable of occurring. In this hedge relationship, the forecasted transactions are the quarterly LIBOR payments through January 1, 20X6. Since Company A will not be making LIBOR payments past June 30, 20X3 due to LIBOR being discontinued on that date (and may cease sooner if the contract is modified), it would benefit from the relief provided by ASC 848.

Company A therefore could elect to apply the optional expedient within ASC 848-50-25-2 in which it could assert that the hedged forecasted transaction remains probable in accordance with ASC 815-20-25-15(b). To be eligible for this relief, Company A must conclude that any future modifications to the forecasted transaction will meet the contract modification relief under ASC 848-20-15-2 and ASC 848-20-15-3. The ability to adopt provisions of ASC 848 for hedge accounting relief prior to any modifications being made to the hedged item, hedging instrument, or forecasted transaction is unique to cash flow hedging relationships.

EXAMPLE REF 3-4

Cash flow hedge applying the ASC 848 relief

Assume the same facts as Example REF 3-3. In December 20X2, Company A modifies its interest rate swap to replace the floating leg of the swap with SOFR. However, as of December 31, 20X2, the debt instrument continues to reference LIBOR. It is expected that contractual fallback language that was included in the debt when it was issued will cause the interest rate on the debt to change to SOFR on June 30, 20X3.

Would Company A need to dedesignate its hedge relationship or could it adopt the provisions of ASC 848 to continue its hedge relationship?

Analysis

Company A may utilize certain provision within ASC 848 to continue its hedge relationship.

Company A has changed the critical terms of the hedge relationship by changing the contractual provisions of the hedging instrument (the interest rate swap). Under ASC 815, a change in the critical terms of a hedge relationship would require the hedge relationship to be dedesignated. However, ASC 848-30-25-3 provides an optional expedient that allows a reporting entity to change the critical terms of a hedge relationship and not dedesignate the hedge relationship if the only change in critical terms is due to reference rate reform. Since the only amendment Company A has made to the critical terms of the hedging instrument is to change the floating leg of the swap from LIBOR to SOFR, Company A would not be required to dedesignate the hedge relationship if Company A adopts the optional expedient in ASC 848-30-25-3. In accordance with ASC 848-30-25-4, Company A must update its hedge documentation for the change by the time it performs its next assessment of effectiveness. Assuming Company A performs its effectiveness assessment at quarter end, it would need to update its hedge documentation for the change by December 31, 20X2. Company A would also be allowed to continue to apply the probability of a forecasted transaction relief described in Example REF 3-4 since the hedged forecasted transaction remains LIBOR.

Company A must also now perform its effectiveness assessment as of December 31, 20X2 and notes that the floating rate of the hedging instrument (SOFR) no longer references the same rate as the hedged item (LIBOR). However, ASC 848 provides for an additional optional expedient in assessing hedge effectiveness. Since Company A uses the hypothetical derivative method to assess effectiveness, ASC 848-50-35-9 provides an optional expedient that a reporting entity may disregard the following critical terms in assessing whether the method will result in a perfectly effective hedge:

- The same repricing dates in accordance with ASC 815-30-35- 25(b)(2)
- The same index in accordance with ASC 815-30-35-25(b)(3)
- Mirror image caps and floors (including a cap or floor that exists in a variable-rate asset or a variable-rate liability and does not exist in a hedging instrument or vice versa) in accordance with ASC 815-30- 35-25(b)(4)

While the hedging instrument and the hedged risk no longer reference the same index, the optional relief of ASC 848 allows Company A to disregard the criteria in ASC 815-30-35-25(b)(3) and continue

to assert that the hedge is perfectly effective under the hypothetical derivative method. Company A elects to use this practical expedient and updates its hedge documentation.

EXAMPLE REF 3-5

Cash flow hedge applying the ASC 848 relief

Assume the same facts as Examples REF 3-3 and REF 3-4. On June 30, 20X3, the debt instrument issued by Company A switches from referencing LIBOR to referencing SOFR as a result of fallback language that was included in the debt agreement. The hedging instrument remains a receive SOFR, pay fixed rate interest rate swap.

How should Company A consider the guidance in ASC 848 for the hedge relationship?

Analysis

ASC 848 provides several optional expedients that Company A can utilize when the contractually specified interest rate being hedged in a cash flow hedge is modified due to reference rate reform.

ASC 848-30-25-3 provides an optional expedient that allows a reporting entity to change the critical terms of a hedge relationship and not dedesignate the hedge relationship if the change in critical terms was due to reference rate reform. Since the contractual cash flows of the hedged item changed due to reference rate reform, Company A elects to apply this relief and the change in the critical terms of the hedge relationship would not require dedesignation. In accordance with ASC 848-30-25-4, Company A should update its hedge documentation to reflect the updated hedged risk, which would now be the changes in cash flows of the quarterly SOFR interest payments due to changes in SOFR.

However, since the hedged risk is now SOFR and the hedging instrument references SOFR, the hedge relationship no longer is affected by (or expected to be affected by) reference rate reform. As a result, the hedge relationship no longer qualifies for the relief in ASC 848. ASC 848-50-35-19 notes that a reporting entity shall discontinue the use of the optional expedients for assessing cash flow hedge effectiveness in ASC 848-50-35-1 through ASC 848-50-35-18 if neither the hedged item nor the hedging instrument references a rate that meets the scope of paragraph ASC 848-10-15-3. Therefore, in order to assess effectiveness as of June 30, 20X3, Company A must follow the requirements of ASC 815. The updated hedge relationship (hedging the variability in cash flows due to changes in the contractually specified SOFR rate using a SOFR-based interest rate swap) must be deemed to be highly effective under the requirements of ASC 815 to continue as a hedge relationship. As permitted by ASC 848-50-35-20, Company A may choose any method to assess effectiveness upon leaving the ASC 848 relief. However, the method chosen to be used as of June 30, 20X3 (in this example) must be utilized for the remainder of the hedge relationship. In addition, Company A is no longer eligible to apply the relief on assessing the probability discussed in Example REF 3-3 and Example REF 3-4.

Company A chooses to continue applying the hypothetical derivative method. However, due to the fact that different SOFR products might have varying calculation methodologies, the terms of the hypothetical derivative may no longer exactly match the terms of the actual hedging instrument. In that scenario Company A would need to quantitatively assess effectiveness using the hypothetical derivative method. Refer to REF 3.4.2.1 for further discussion on creating the hypothetical derivative upon exiting the ASC 848 relief.

3.3.6.8 Applying simplified hedge account approach

For certain entities (e.g., private companies other than financial institutions) that are able to apply ASC 815-20-25-135, the criteria in ASC 848-50-25-8 (repeated in ASC 848-50-35-7) may be disregarded in determining whether a cash flow hedge of a variable rate borrowing with a receive-variable pay-fixed interest rate swap using the simplified hedge accounting approach (see DH 11.2) may be considered perfectly effective in accordance with ASC 815-20-25-133 through ASC 815-20-25-138. This guidance may be applied if either the hedging instrument or the hedged forecasted transaction references LIBOR or reference rate expected to be discontinued due to reference rate reform.

Excerpt from ASC 848-50-25-8 and ASC 848-50-35-7

a. Both the variable rate on the swap and the borrowing are based on the same index and reset period in accordance with paragraph 815-20-25-137(a).

b. The terms of the swap are typical in accordance with paragraph 815-20-25-137(b).

c. The repricing and settlement dates for the swap and the borrowing match in accordance with paragraph 815-20-25-137(c).

3.3.7 Adjusting AOCI – the discounting transition

ASC 848-30-25-11C provides an optional expedient for a cash flow hedge to allow a reporting entity to adjust accumulated other comprehensive income for the amount of cash compensation paid or received related to the change in the interest rate used for margining, discounting, or contract price alignment using a reasonable approach. A reporting entity should use a similar method for similar hedges. If different approaches for similar hedges are used, the reporting entity must justify its rationale.

3.3.8 Hedging forecasted transactions – impact to AOCI

As discussed throughout this chapter, under certain circumstances, ASC 848 allows a reporting entity to update its hedge documentation following a change to the critical terms of that hedge relationship without dedesignating the hedge. For example, a reporting entity may change the forecasted transaction and the designated hedge risk from quarterly LIBOR payments to monthly payments based on overnight SOFR. This ability to update the hedge documentation also affects when a reporting entity may be required to reclassify amounts in AOCI related to that hedge relationship into earnings. These amounts are reclassified from AOCI to earnings based on the hedge documentation. As a result, if the hedge documentation is updated through the application of ASC 848, then reclassification of amounts from AOCI to earnings will be determined based on the updated hedge documentation.

ASC 815 states that amounts in AOCI should be reclassified immediately into earnings if a hedged forecasted transaction in a cash flow hedging relationship is probable of not occurring. Even if a hedge relationship is dedesignated, if the previously hedged forecasted transaction is not probable of not occurring, amounts in AOCI relating to that now dedesignated hedge relationship should continue to be reclassified into earnings as the forecasted transaction impacts earnings.

Questions may arise as to when amounts in AOCI need to be recognized in earnings when hedge relationships are modified due to reference rate reform. This may also include scenarios in which a hedged item or hedged forecasted transaction in a hedge relationship that was previously terminated/dedesignated is now being modified due to reference rate reform.

Examples REF 3-6, REF 3-7, REF 3-8, and REF 3-9 illustrate different scenarios involving active and dedesignated cash flow hedges of forecasted transactions that are modified due to reference rate reform and the impact to amounts in AOCI.

EXAMPLE REF 3-6

Cash flow hedge of a forecasted transaction where the hedged item is modified for changes both related and unrelated to reference rate reform

On January 1, 20X1, Company A issues a five-year floating rate debt instrument (Debt ABC) that pays quarterly interest at USD LIBOR with no additional spread. Company A wants to hedge the variability in interest payments of Debt ABC due to the contractually specified USD LIBOR rate. Company A enters into a fixed-to-float interest rate swap with a maturity of five years where Company A will receive USD LIBOR and pay a fixed rate of 3%. The interest rate swap also pays quarterly interest. Company A designates this swap as a hedging instrument to hedge the variability of the forecasted interest payments due to changes in the contractually specified rate, which is LIBOR. Company A states within its hedge documentation that it is hedging quarterly LIBOR-based payments based on the contractual payments from Debt ABC. Company A elects to apply the guidance in ASC 848-50-25-2 permitting it to continue to assert that Company A would make LIBOR-based interest payments on Debt ABC. The hedge documentation does not refer to any replacement debt; it is specific to interest payments required by a specific debt instrument.

In early 20X2, Company A negotiates with Debt ABC's counterparty to amend the terms of Debt ABC. The modification to the terms of the debt includes replacing the quarterly USD LIBOR payments with monthly payments based on overnight SOFR in arrears and extending the maturity of the debt by one year (so that it would mature on January 1, 20X7 instead of January 1, 20X6).

Can Company A utilize the optional expedients in ASC 848 to change the critical terms of the hedge relationship and amend the hedge documentation without dedesignating the hedge relationship? Additionally, should Company A immediately reclassify amounts in AOCI related to the hedge relationship into earnings due to a hedged forecasted transaction being probable of not occurring?

Analysis

We believe Company A would not be eligible for the optional expedients in ASC 848 and would have to dedesignate its hedge relationship and immediately reclassify amounts in AOCI relating to this hedge relationship into earnings upon modification of Debt ABC.

ASC 848-30-25-5 states a reporting entity may change the contractual terms of a hedge relationship including a forecasted transaction without dedesignating the hedge relationship if the changes to the contractual terms meet the scope of ASC 848-20-15-2 and ASC 848-20-15-3. Additionally, ASC 848-50-25-3 permits a reporting entity to change the designated hedged interest rate risk in connection with reference rate reform. However, ASC 848-20-15-3 states that the relief in ASC 848 does not apply to contract modifications that include changes unrelated to reference rate reform, and if made contemporaneously with changes related to reference rate reform, the entire modification is not within

the scope of ASC 848. One of the examples provided by ASC 848 of a change unrelated to reference rate reform is a change to the maturity date.

Since Company A's hedge documentation is specific that it is hedging three-month LIBOR-based payments to be made on a specific debt instrument (Debt ABC), we believe the hedged forecasted transaction is solely linked to the Debt ABC contract. The debt instrument was amended in a manner (the extension of its maturity) that would make the modification ineligible for the relief in ASC 848-20-15-3. Therefore, this modification to the hedged item is not eligible for the relief in ASC 848-30-25-5, and Company A would have to dedesignate the hedge relationship.

Since Company A does not qualify for the ASC 848 relief, it would not be permitted to update its hedge documentation that states that it is hedging LIBOR-based payments to be made quarterly on Debt ABC. Once the debt modification is made, the forecasted transaction would no longer be a rate that is expected to be replaced due to reference rate reform, and Company A could no longer apply the relief in ASC 848-50-25-2. It would also be now probable that the hedged forecasted transaction of LIBOR-based payments would not occur (since Debt ABC would make overnight SOFR payments in the future). As a result, all amounts in AOCI related to Debt ABC should be immediately reclassified into earnings, and Company A has a missed forecasted transaction that would be required to be considered and disclosed in accordance with the provisions of ASC 815.

EXAMPLE REF 3-7

Cash flow hedge of a forecasted transaction with amounts in AOCI where the hedged item and hedging instrument are modified for changes both related and unrelated to reference rate reform

On January 1, 20X1, Company A issues a five-year floating rate debt instrument (Debt ABC) that pays quarterly interest at USD LIBOR with no additional spread. Company A wants to hedge the variability in USD LIBOR-based interest payments initially created by Debt ABC. Company A enters into a fixed-to-float interest rate swap with a maturity of five years where Company A will receive USD LIBOR and pay a fixed rate of 3%. The interest rate swap also pays quarterly interest. Company A designates this swap as a hedging instrument to hedge the variability of the forecasted interest payments due to changes in the contractually specified rate, which is LIBOR. Company A states within its hedge documentation that the initial source of the interest payments is Debt ABC, but the forecasted transaction could be any debt that replaces Debt ABC if it is refinanced. Company A elects to apply the guidance in ASC 848-50-25-2 permitting it to continue to assert that Company A would make LIBOR-based interest payments on Debt ABC.

In January of 20X2, Company A negotiates with Debt ABC's counterparty to amend the terms of Debt ABC. The modification to the terms of the debt includes replacing quarterly payments of USD LIBOR with monthly payments of overnight SOFR in arrears and extending the maturity of the debt by one year (i.e., maturing on January 1, 20X7 instead of January 1, 20X6). Subsequent to modifying Debt ABC, Company A also modifies the interest rate swap used as the hedging instrument to switch the reference interest rate from LIBOR to SOFR and to extend the maturity to January 1, 20X7.

Can Company A utilize the optional expedients in ASC 848 to change the critical terms of the hedge relationship and amend the hedge documentation without dedesignating the hedge relationship? Additionally, should Company A immediately reclassify amounts in AOCI related to the hedge relationship into earnings due to a hedged forecasted transaction no longer being probable of occurring?

Analysis

We believe Company A would be able to utilize the optional expedients in ASC 848 to continue hedge accounting and update its hedge documentation upon the modification to Debt ABC. While the hedge relationship would be dedesignated upon the modification to the hedging instrument, Company A would not have to immediately reclassify amounts in AOCI into earnings since the updated hedged forecasted transaction is still probable of occurring.

ASC 848-30-25-5 states a reporting entity may change the contractual terms of a hedge relationship including the forecasted transaction without dedesignating the hedge relationship if the changes to the contractual terms meet the scope of ASC 848-20-15-2 and ASC 848-20-15-3. Additionally, ASC 848-50-25-3 permits a reporting entity to change the designated hedged interest rate risk in connection with reference rate reform. ASC 848-20-15-3 states that the relief in ASC 848 does not apply to contract modifications that include changes unrelated to reference rate reform, and if made contemporaneously with changes related to reference rate reform, the entire modification is not within the scope of ASC 848. One of the examples provided by ASC 848 of a change unrelated to reference rate reform is a change to the maturity date.

Company A's hedge documentation states that it is hedging LIBOR payments on Debt ABC or any debt that replaces Debt ABC. Company A's hedge documentation contemplates forecasted transactions (LIBOR-based interest payments) under a currently existing contractual relationship (Debt ABC) as well as the potential that forecasted transactions may come from future contractual relationships that do not yet exist (refinanced debt). ASC 848-30-25-5 includes references to changes in contractual terms, but it also refers to forecasted transactions. Forecasted transactions may or may not be generated by existing contracts; they also may be generated by contracts that do not currently exist. As a result, we believe that it would be reasonable to conclude based on the nature of the documented forecasted transaction that the requirement to assess changes in the contractual terms under ASC 848-20-15-2 and ASC 848-20-15-3 would not be applicable. ASC 848-50-25-3 permits a reporting entity to change the designated hedged interest rate risk in connection with reference rate reform. The forecasted transactions and hedged risk are not linked to the contractual terms of any individual debt instrument (since the hedge documentation is not limited to one specific debt instrument but is documented to also include any debt instrument that may replace the existing debt). The only change to the critical terms of this hedge relationship is replacing quarterly LIBOR-based payments with overnight SOFR in arrears monthly payments. Since this change is directly related to reference rate reform, Company A could utilize the expedients in ASC 848-30-25-5 to update the critical terms of the hedge relationship, ASC 848-50-25-3 to change the hedged risk, and ASC 848-30-25-4 to update its hedge documentation. Company A would update its hedge documentation to state that it is hedging overnight SOFR in arrears monthly payments on Debt ABC, or any debt that replaces Debt ABC if refinanced.

However, subsequent to the modification of Debt ABC, Company A also modifies the interest rate swap used as the hedging instrument. The change to the contractual terms of the hedging instrument includes a change unrelated to reference rate reform (i.e., the extension of the maturity date). As a result, the modification to the derivative instrument would not be eligible for the contract modification relief in ASC 848, and the modification would be deemed a termination of the original derivative and the entering into of a new derivative. As a result, the hedge relationship must be dedesignated on the date the interest rate swap is modified.

Since Company A previously updated its hedge documentation to reflect that it is now hedging overnight SOFR in arrears payments, the forecasted transaction would still be expected to occur despite the hedge being dedesignated. Therefore, Company A would continue to reclassify amounts previously accumulated in OCI into earnings as the forecasted transactions (overnight SOFR in arrears payments) occur.

We believe a similar conclusion would be reached even if the interest rate swap was modified prior to the debt being modified. In that scenario, we believe the modification of the interest rate swap would cause the hedge relationship to be dedesignated since it includes a modification to a term unrelated to reference rate reform. However, as described further in Example REF 3-8 and REF 3-9, we believe the provisions of ASC 848 can apply to a dedesignated hedge. Therefore, when Company A modifies Debt ABC, it is able to use ASC 848 to modify the hedge documentation to reflect that the hedged forecasted transaction is now overnight SOFR in arrears payments and continue to reclassify amounts previously accumulated in OCI in earnings as the forecasted transactions (overnight SOFR in arrears payments) occur.

EXAMPLE REF 3-8

Dedesignated cash flow hedge of a forecasted transaction with amounts in AOCI where the hedged item is modified due to reference rate reform after the hedge was dedesignated

On January 1, 20X1, Company A issues a five-year floating rate debt instrument (Debt ABC) that pays quarterly interest based on USD LIBOR with no additional spread. Company A wants to hedge the variability in interest payments of Debt ABC due to the contractually specified USD LIBOR rate. Company A enters into a fixed-to-float interest rate swap with a maturity of five years where Company A will receive USD LIBOR and pay a fixed rate of 3%. The interest rate swap also pays quarterly interest. Company A designates this swap as a hedging instrument hedging the variability of the forecasted interest payments due to changes in the contractually specified rate, which is LIBOR. Company A's hedge documentation states that it is hedging LIBOR-based payments to be made quarterly based on the contractual payments from Debt ABC. Company A elects to apply the guidance in ASC 848-50-25-2 permitting it to continue to assert that Company A would make LIBOR-based interest payments on Debt ABC.

On January 1, 20X2, Company A voluntarily dedesignates the hedge relationship and terminates the interest rate swap. Because Company A elected to apply the guidance in ASC 848-50-25-2, Company A assumes that hedged forecasted transactions are still expected to occur. As a result, amounts accumulated in OCI will continue to be reclassified into earnings as the forecasted transactions occur.

On January 1, 20X3, Company A negotiates with Debt ABC's counterparty to amend the terms of Debt ABC. The only modification to the terms of Debt ABC is to replace quarterly USD LIBOR-based interest payments with monthly payments based overnight SOFR in arrears.

Given the modification of Debt ABC occurred subsequent to the hedge relationship being dedesignated, is Company A eligible to use the expedients in ASC 848 to amend the hedge documentation to avoid needing to immediately reclassify amounts in AOCI into earnings?

Analysis

We believe Company A is eligible to utilize the optional expedients in ASC 848 to update its hedge documentation so that it would not immediately need to reclassify amounts in AOCI into earnings.

Once Debt ABC's terms are modified from LIBOR-based interest payments to SOFR-based interest payments, Company A would no longer be eligible to apply the guidance in ASC 848-50-25-2 and assume that LIBOR-based interest payments will continue. While not explicitly addressed in ASC 848, we believe certain provisions within ASC 848 can be applied to dedesignated hedge relationships. Although a hedging relationship may have been dedesignated, the hedge documentation would still impact the accounting of Company A as the documented hedged item governs how and when amounts in AOCI should be reclassified to current earnings. In addition, ASC 815 requires that amounts in AOCI be evaluated to determine if they should be reclassified to earnings because the forecasted transaction is probable of not occurring, even for dedesignated hedges.

ASC 848-30-25-5 states a reporting entity may change the forecasted transaction without having to dedesignate the hedge relationship if the changes to the contractual terms meet the scope of ASC 848-20-15-2 and ASC 848-20-15-3. A change solely related to reference rate reform, such as replacing a LIBOR-based reference rate with SOFR, is an eligible modification under ASC 848-20-15-2 and ASC 848-20-15-3. ASC 848-50-25-3 permits a reporting entity to change the designated hedged interest rate risk in connection with reference rate reform.

Therefore, the modification to the forecasted transaction and hedged risk to state that it is hedging monthly overnight SOFR in arrears payments on Debt ABC would be eligible for the relief in ASC 848-30-25-5 and ASC 848-50-25-3.

Since Company A updated its hedge documentation to reflect that it is now hedging overnight SOFR in arrears payments, the forecasted transaction would still be expected to occur despite the changes in the contractual terms of Debt ABC and the inability to apply ASC 848-50-25-2 (assuming Company A can demonstrate Debt ABC will remain outstanding). Therefore, Company A would reclassify amounts previously accumulated in OCI into earnings as the forecasted transactions (overnight SOFR in arrears payments) occur.

EXAMPLE REF 3-9

Dedesignated cash flow hedge of a forecasted transaction with amounts in AOCI where the hedged item is modified due to changes both related and unrelated to reference rate reform after the hedge was dedesignated

On January 1, 20X1, Company A issues a five-year floating rate debt instrument (Debt ABC) that pays quarterly interest based on USD LIBOR with no additional spread. Company A wants to hedge the variability in interest payments of Debt ABC due to the contractually specified USD LIBOR rate. Company A enters into a fixed-to-float interest rate swap with a maturity of five years where Company A will receive USD LIBOR and pay a fixed rate of 3%. The interest rate swap also pays quarterly interest. Company A has designated this swap as a hedging instrument to hedge the variability of the forecasted interest payments due to changes in the contractually specified rate, which is LIBOR. Company A states within its hedge documentation that it is hedging LIBOR-based payments to be made quarterly on Debt ABC or any debt replacing Debt ABC if refinanced. Company A elects to apply the guidance in ASC 848-50-25-2 permitting it to continue to assert that Company A would make LIBOR-based interest payments on Debt ABC or any debt replacing Debt ABC. On January 1, 20X2, Company A voluntarily dedesignates the hedge relationship and terminates the interest rate swap; however, Debt ABC is not modified. Because Company A elects to apply the guidance in ASC 848-50-25-2, Company A assumes that hedged forecasted transactions are still expected to occur. As a result, amounts accumulated in OCI will continue to be reclassified into earnings as the forecasted transactions occur.

On January 1, 20X3, Company A negotiates with Debt ABC's counterparty to amend the terms of Debt ABC. The modification to the terms of the debt includes replacing quarterly USD LIBOR-based interest payments with monthly payments based on overnight SOFR in arrears and extending the maturity of the debt by one year (i.e., maturing on January 1, 20X7 instead of January 1, 20X6).

Given the modification of Debt ABC occurred subsequent to the hedge relationship being dedesignated, is Company A eligible to use the expedients in ASC 848 to amend the hedge documentation to avoid needing to immediately reclassify amounts in AOCI into earnings?

Analysis

We believe Company A is eligible to utilize the optional expedients in ASC 848 to update its hedge documentation so that it would not immediately need to reclassify amounts in AOCI into earnings.

Once Debt ABC's terms are modified from LIBOR-based interest payments to SOFR-based interest payments, Company A would no longer be eligible to apply the guidance in ASC 848-50-25-2 and assume that LIBOR-based interest payments will continue. While not explicitly addressed in ASC 848, we believe certain provisions within ASC 848 can be applied to dedesignated hedge relationships. Although the hedging relationship may have been dedesignated, the hedge documentation still impacts the accounting of Company A as the documented hedged item governs how and when amounts in AOCI should be reclassified to current earnings. In addition, ASC 815 requires that amounts in AOCI be evaluated to determine if they should be reclassified to earnings because the forecasted transaction is probable of not occurring, even for dedesignated hedges.

ASC 848-30-25-5 states a reporting entity may change the contractual terms of a hedge relationship including the forecasted transaction without having to dedesignate the hedge relationship if the changes to the contractual terms meet the scope of ASC 848-20-15-2 and ASC 848-20-15-3. ASC 848-20-15-3 states that the relief in ASC 848 does not apply to contract modifications that are unrelated to reference rate reform, or contract modifications that contemporaneously modify terms both related and unrelated to reference rate reform. One of the examples provided by ASC 848 of a change unrelated to reference rate reform is a change to the maturity date.

Company A's hedge documentation states that it is hedging LIBOR payments on Debt ABC or any debt that replaces Debt ABC. Company A's hedge documentation contemplates forecasted transactions (LIBOR-based interest payments) that are governed by a currently existing contractual relationship (Debt ABC) as well as the potential that forecasted transactions may come from future contractual relationships that do not yet exist (refinanced debt). ASC 848-30-25-5 includes references to changes in contractual terms, but it also refers to forecasted transactions. Forecasted transactions may or may not be generated by existing contracts; they also may be generated by contracts that do not currently exist. As a result, we believe that it would be reasonable to conclude in this situation based on the nature of the documented forecasted transaction that the requirement to assess changes in the contractual terms under ASC 848-20-15-2 and ASC 848-20-15-3 would not be applicable. ASC 848-50-25-3 permits a reporting entity to change the designated hedged interest rate risk in connection with reference rate reform. The forecasted transactions and hedged risk are not linked to the contractual terms of any individual debt instrument (since the hedge documentation is not limited to one specific debt instrument but is documented to also include any debt instrument that may replace the existing debt). The only change to the critical terms of this hedge relationship is replacing quarterly LIBOR-based payments with overnight SOFR in arrears monthly payments. Since this change is directly related to reference rate reform, Company A could utilize the expedients in ASC 848-30-25-5 to update the critical terms of the hedge relationship, ASC 848-50-25-3 to change the

hedged risk, and ASC 848-30-25-4 to update its hedge documentation. Company A would update its hedge documentation that it is hedging overnight SOFR in arrears monthly payments on Debt ABC, or any debt that replaces Debt ABC if refinanced. If Company A had not documented the original hedge relationship to include forecasted transactions related to replacement debt and only was hedging interest payments on Debt ABC, we believe that ASC 848-30-25-5 would not be able to be applied since a contractual change occurred unrelated to reference rate reform that impacted the documented hedged forecasted transaction.

Since Company A updated its hedge documentation to reflect that it is now hedging overnight SOFR in arrears payments, the forecasted transaction would still be expected to occur despite the changes in the contractual terms of Debt ABC and the inability to apply ASC 848-50-25-2 (assuming Company A can demonstrate Debt ABC will remain outstanding). Therefore, Company A would reclassify amounts previously accumulated in OCI into earnings as the forecasted transactions (overnight SOFR in arrears payments) occur.

3.4 Discontinuance of hedge effectiveness optional expedients

The guidance in ASC 848 is meant to provide temporary relief and, in many instances will require discontinuance.

3.4.1 Fair value hedge optional expedients

ASC 848 provides a reporting entity with an optional expedient when determining if a fair value hedging relationship can be assumed to be highly effective under the shortcut method (see REF 3.2.2). This expedient may be applied throughout the life of the hedging relationship, even in instances when the life of the hedging relationship extends beyond December 31, 2024. That is, the ability to apply the shortcut method optional expedient may continue to be applied until (1) the hedging relationship ceases to exist or (2) a reporting entity voluntarily discontinues the hedging the relationship unless a reporting entity elects the practical expedient in accordance with ASC 848-30-25-10 to combine two or more derivatives as the hedging instrument in a hedging relationship and continue to apply the shortcut method. In this instance, the reporting entity must cease applying the shortcut method after December 31, 2024, and must change to assessing hedge effectiveness using a method prescribed in ASC 815-20 and ASC 815-25.

ASC 848 also provides a reporting entity with the ability to change the designated benchmark interest rate hedged and component of cash flows (see REF 3.2.1) and, when doing so, requires a reporting entity to update the discount rate used and permits it to incorporate other adjustments to the calculation. If the hedging relationship extends beyond December 31, 2024, ASC 848-40-25-6 states that a reporting entity should continue to use the revised discount rate (including any spread adjustment, if applicable) and any remaining revised cash flows over the life of the designated hedging relationship.

3.4.2 Cash flow hedge optional expedients

The guidance in ASC 848 is meant to provide relief on a temporary basis for both existing and new cash flow hedges. As a result, entities should discontinue using an optional expedient for assessing

hedge effectiveness if any of the following occur prior to December 31, 2024 for each hedging relationship in which an optional expedient was elected:

- Neither the hedged item nor the hedging instrument reference a rate that meets the scope of ASC 848-10-15-3 (i.e., references LIBOR or a reference rate that is expected to be discontinued as a result of reference rate reform).
- The guidance in ASC 848 is superseded, which will occur after the December 31, 2024 sunset date (see REF 4.1.4 for certain exceptions).
- The reporting entity elects to cease to apply the optional expedients.

For hedging relationships that cease to apply ASC 848 (e.g., extend beyond December 31, 2024 or a reporting entity no longer qualifies to apply the guidance), a reporting entity should apply the guidance in ASC 815-20 and ASC 815-30 to determine if hedge accounting should continue to be applied. Any eligible method for assessing effectiveness under ASC 815-20 and ASC 815-30 may be applied without requiring dedesignation, including a method other than the one designated for use prior to the optional expedient being applied. In accordance with ASC 848-50-35-21, if a reporting entity chooses to assess hedge effectiveness using the hypothetical derivative method, or another acceptable method under ASC 815-20 and ASC 815-30, the reporting entity may create the terms of the instrument used to estimate changes in the fair value of its hedged risk based on market data as of hedge inception.

If a new method is selected, a reporting entity should update its hedge documentation noting the changes made no later than when the reporting entity performs its first assessment of effectiveness after the change was identified in accordance with ASC 848-30-25-4. ASC 848 specifically notes that a reporting entity must continue to assess whether the underlying hedged forecasted transaction is probable of occurring.

If it is determined that the hedging relationship no longer qualifies for hedge accounting, hedge accounting should be discontinued prospectively and ASC 815-30-40-2 through ASC 815-30-40-6A should be applied.

3.4.2.1 Hypothetical derivative method when existing relief

ASC 848-50-35-21 provides guidance on how to apply the hypothetical derivative method for cash flow hedges when assessing effectiveness for a hedge relationship that is exiting the relief offered by ASC 848.

Excerpt from ASC 848-50-35-21

An entity may create the terms of the instrument used to estimate changes in the fair value of the hedged risk (in accordance with either the hypothetical derivative method or another acceptable method in Subtopics 815-20 and 815-30) on the basis of market data as of the inception of the hedging relationship.

Upon exiting the relief offered by ASC 848, either because the hedge relationship no longer references a rate expected to be discontinued, the sunset date of ASC 848 has occurred, or a reporting entity elects to stop applying the expedients in ASC 848, a reporting entity is required to assess the

effectiveness of the hedge relationship in accordance with ASC 815. When using the hypothetical derivative method, questions may arise on how to construct the hypothetical derivative. Under the hypothetical derivative method, the assessment of hedge effectiveness is based on a comparison of (1) the change in fair value of the actual swap designated as the hedging instrument and (2) the change in fair value of a hypothetical swap. The hypothetical swap must have a fair value of zero at the inception of the hedging relationship and terms that exactly match the critical terms of the hedged item. If a reporting entity was using the hypothetical derivative method prior to entering the ASC 848 relief, the hypothetical derivative would have been created based on the rates designated as the hedged item (e.g., LIBOR). Upon existing the relief, both the hedging instrument (i.e., the interest rate swap) and the hedged item will now reference a new interest rate (e.g., SOFR). The creation of a hypothetical derivative with a fair value of zero as of the date the relationship exits the relief in ASC 848 could cause significant ineffectiveness in the hedge relationship since the actual swap will not have a fair value of zero.

Question REF 3-1

How should a reporting entity construct the hypothetical derivative when it elects to assess effectiveness of a cash flow hedge using the hypothetical derivative method upon exiting the ASC 848 relief?

PwC response

We believe that there are multiple approaches a reporting entity can use to construct a hypothetical derivative for purposes of assessing hedge effectiveness upon exiting the relief and on a going-forward basis. As noted in ASC 848-50-35-21, a reporting entity may elect to create the hypothetical derivative based on market data as of the inception of the hedging relationship. If a reporting entity elects to create the hypothetical derivative using this guidance, it would use market data as of the beginning of the hedge relationship, not when the hedge relationship was modified as a result of reference rate reform or when the hedge relationship exited the relief provided by ASC 848.

We believe a reporting entity could create a hypothetical derivative under one of three approaches:

- *Assume the hedge relationship was always based on the new reference rate*

  Under this approach a reporting entity would create a hypothetical derivative that would have had a fair value of zero at hedge inception (using market data as of the date of hedge inception) which references the new reference rate for the entirety of the hedge relationship.

- *Assume the hedge relationship was indexed to the original reference rate through the date the hedged item was amended to a new reference rate, and then indexed to the new reference rate*

  This would involve creating a hypothetical derivative that has a fair value of zero at hedge inception (using market data as of the date of hedge inception) and, for example, references LIBOR and then switches to SOFR.

- *Assume that the hypothetical derivative contained the same fallback protocols*

  If the actual derivative included (or was amended to include) industry standard fallback protocols to change the terms of the swap solely in response to reference rate reform, a reporting entity can

assume that the hypothetical derivative contained the same fallback protocols. As a result, the terms of the hypothetical derivative would be changed based on those fallback protocols.

We believe that a reporting entity could also choose to dedesignate its hedge relationship, redesignate the hedge upon exiting the relief, and create a new hypothetical derivative that has a fair value of zero as of the date of exit based on market data available at that time using the new reference rate.

3.4.3 Fair value, cash flow and net investment hedge optional expedient

ASC 848 provides a reporting entity with an optional expedient to prospectively change its systematic and rational method used to recognize excluded components in earnings (see REF 3.1.5). If this optional expedient is elected for a cash flow hedge, fair value hedge, or net investment hedge, the amended systematic and rational method must be applied for the remaining life of the hedging relationship, including periods subsequent to December 31, 2024.

Chapter 4: Effective date and transition

4.1 Effective date and transition

The guidance in ASC 848 was available to be adopted upon issuance for all entities. While it provided immediate accounting relief (if adopted), the relief is meant to be temporary (see REF 4.1.4), as reference rate reform is considered temporary in nature due to the expectation that certain LIBOR settings will be discontinued by the end of 2021, with the remainder discontinued in 2023. The relief provided within ASC 848 lasts until December 31, 2024.

4.1.1 Contract modifications effective date and transition

As discussed in REF 1.3, the guidance must be elected for contract modifications for arrangements within a given ASC Topic or Industry Subtopic (e.g., all lease modifications within ASC 842). A reporting entity may elect to adopt the guidance for contract modifications:

- as of any date from the beginning of an interim period that includes or is subsequent to March 12, 2020, or
- prospectively from a date within an interim period that includes or is subsequent to March 12, 2020.

A calendar year-end company, for example, could have adopted the guidance in Q1 2020.

Once the application of ASC 848 is elected for an ASC Topic or an Industry Subtopic, it needs to be applied prospectively for all eligible contract modifications for that ASC Topic or Industry Subtopic (see REF 1.3) made prior to December 31, 2024. However, it may be elected for different ASC Topics or Industry Subtopics during different reporting periods. For example, a company may elect to apply an optional expedient for all contract modifications that would have been accounted for under ASC 310 in Q1 but elect to apply an optional expedient for all contract modifications that would have been accounted for under ASC 470 in Q2.

A reporting entity may elect the guidance in ASU 2021-01 for contract modifications of derivatives that change the interest rate used for margining, discounting, or contract price alignment:

- retrospectively as of any date from the beginning of an interim period that includes or is subsequent to March 12, 2020, or
- prospectively to new modifications within the interim period including or subsequent to January 7, 2021.

Once elected, the guidance must be applied for all contract modifications that change the derivatives interest rate used for margining, discounting, or contract price alignment.

4.1.2 Hedge accounting effective date and transition

ASC 848 can be applied to eligible 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. The optional expedients may not be applied, however, to hedging relationships evaluated after December 31, 2024 (with limited exceptions described in REF 4.1.5).

Excerpt from ASC 848-10-65-1(a)(2)(i)

If an entity elects to apply any of the pending content that links to this paragraph for an eligible hedging relationship existing as of the beginning of the interim period that includes March 12, 2020, any adjustments as a result of those elections shall be reflected as of the beginning of that interim period and recognized in accordance with Subtopics 848-30, 848-40, and 848-50 (as applicable). If an entity elects to apply any of the pending content that links to this paragraph for a new hedging relationship entered into between the beginning of the interim period that includes March 12, 2020 and March 12, 2020, any adjustments as a result of those elections shall be reflected as of the beginning of the hedging relationship and recognized in accordance with Subtopics 848-30, 848-40, and 848-50 (as applicable).

A reporting entity may elect the guidance in ASU 2021-01 for hedge accounting to eligible hedging relationships (See REF 3.1.1 for the scope of hedge relationships eligible for the guidance in ASU 2021-01):

- as of the beginning of any interim period that includes March 12, 2020, and
- new eligible hedging relationships entered into after the beginning of an interim period that includes March 12, 2020.

Question REF 4-1 addresses the application of the hedge accounting relief when the election occurs in a subsequent reporting period to the period in which the qualifying event occurred.

Question REF 4-1

In Q1 20X1, a reporting entity elects to adopt the optional expedient in ASC 848-30-25-11C to adjust the amount in accumulated other comprehensive income for a cash flow hedge affected by a cash settlement relating to a change in interest rate used for margining, discounting, or contract price alignment. The interest rate used for margining, discounting, or contract price alignment changed in Q4 20X0. When should the adjustment be recognized?

PwC response

The reasonable method used to adjust the amount in accumulated other comprehensive income should be applied retrospectively to Q4 20X0, as this is the reporting period in which the derivative's interest rate changed. ASC 848-10-65-2(a)(2) states that if a reporting entity elects to apply the guidance in ASU 2021-01 to any hedging relationship, "any adjustments as a result of those elections shall be reflected as of the application date of the election." It is our understanding that the application date is the date that the modification of the derivative occurred and the optional expedient is applied to that event. Therefore, a reporting entity that elects to apply an optional expedient to an event that occurred in a prior reporting period should apply a reasonable method to adjust the amount in accumulated other comprehensive income retrospectively and revise Q4 20X0 within subsequent financial statements.

4.1.3 Transition disclosures

ASC 848-10-65-1(e) and ASC 848-10-65-2(d) require reporting entities that have elected to apply the guidance in ASC 848 to disclose the nature of and reason for electing to apply an optional expedient

under ASC 848. Disclosure must be made in each interim and annual period in the fiscal year of application.

4.1.4 ASC 848 sunset date

The guidance in ASC 848 cannot be applied to contract modifications or hedging relationships after December 31, 2024 with limited exceptions. Those limited exceptions relate to certain hedging optional expedients that, if elected, would continue to be applied subsequent to December 31, 2024. Those exceptions pertain to:

- the optional expedient to change the systematic and rational method used to recognize in earnings excluded components (see REF 3.1.5),
- the approach to measuring the hedged item in a fair value hedge resulting from the optional expedient to change the designated benchmark interest rate and component of cash flows (see REF 3.2.1),
- the optional expedient to adjust the fair value hedge basis adjustment using a reasonable method in a fair value hedge accounted for under the shortcut method (see REF 3.2.3),
- the optional expedient to adjust the amount recorded in accumulated other comprehensive income using a reasonable method in a cash flow hedge (see REF 3.3.7), and
- the optional expedient to not periodically evaluate certain conditions when determining whether the shortcut method for assessing hedge effectiveness may continue to be applied for a fair value hedge (see REF 3.2.2).