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The accounting impact of the LIBOR transition

Uncover the potential accounting impact of a shift in benchmark rate

The London Interbank Offered Rate (LIBOR) is expected to be phased out after 30 long years, and the shift to an alternative baseline reference rate could have a cascading effect beyond contract terms into the operations and financial reporting of thousands of institutions. Organizations that don't act now may face increasing costs and resource needs to manage the transition in the coming years.

In July 2017, the Financial Conduct Authority in the UK (FCA), the governing body responsible for regulating LIBOR, announced that it will no longer compel or persuade the panel banks to make LIBOR submissions after 2021. As LIBOR is calculated based on the rates submitted by the panel of banks, the declaration by the FCA is expected to result in the sunset of LIBOR, which is issued for five currencies (U.S dollar, Pound sterling, Japanese yen, Swiss franc and Euro). Following FCA's announcement, the Alternative Reference Rates Committee (ARRC) published Paced Transition Plan[1], which outlines key steps and timelines through 2021 to assist entities with preparing for a smooth transition from LIBOR to an alternative reference rate.

With an estimated $370 trillion[2] of global financial contracts referenced to LIBOR, the impact will be far reaching. Affected companies may see a rise in compliance, financial reporting, staffing and other costs related to the transition. As we discussed in *Moving with the Change*[3], which reviews the potential changes relating to the shifting benchmark rate, firms that have contracts referencing LIBOR should begin planning and preparing as soon as possible to ensure that a transition away from LIBOR has minimal financial and operational impact. In particular, the change in benchmark reference rate could trigger accounting-related issues under both US Generally Accepted Accounting Principles (US GAAP) and International Financial Reporting Standards (IFRS). In an effort to assess the potential accounting implications, the accounting standard setters for US GAAP and IFRS have recently added projects to their agendas to evaluate the need for transition guidance.

As accounting standards setters and market participants explore the breadth of impact, potential accounting issues are coming to light.

The shift in benchmark rates is expected to have wide-ranging accounting impacts, including effects on hedge accounting, debt modification, and discount rates for impairment testing, lease accounting and fair valuation.

[1] The Paced Transition Plan is available at https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/OConnorpresentation.pdf
[2] https://www.isda.org/2018/02/05/the-370-trillion-benchmark-challenge/
[3] "Moving with the change: Planning and preparing a move toward alternative reference rates," KPMG, 2018. Available at: https://home.kpmg.com/us/en/home/insights/2018/08/moving-with-the-change.html

Accounting impacts

Hedge accounting

The LIBOR transition's potential impact on hedge accounting will be most relevant to hedges of interest rate risk. In particular, under both US GAAP and IFRS, hedge accounting must be discontinued prospectively if the hedging instrument is terminated.

A change in the critical terms of a derivative may result in its termination, thereby causing a de-designation of the associated hedging relationship. Hence, if the underlying reference interest rate of a hedging instrument transitions from LIBOR to another benchmark rate, entities need to evaluate whether such a change would be considered a termination of the hedging instrument, resulting in a need to de-designate the hedging relationship, which may result in unexpected income statement volatility going forward.

In a cash flow hedging relationship, entities need to evaluate if the hedged forecasted transactions indexed to LIBOR may become less than 'probable' as we approach a transition to another reference rate. In order to qualify for cash flow hedge accounting, a forecasted transaction must be probable[4] to occur throughout the term of the hedge. An entity is required to discontinue hedge accounting on a prospective basis if the forecasted transaction, as described in the original hedge documentation, is no longer probable of occurring.

Accordingly, to the extent that LIBOR-based cash flows are referenced as the hedged forecasted transactions in an entity's hedge documentation[5], an entity will need to consider the impact of the LIBOR transition on its assessment of the probability of the forecasted transaction.

Furthermore, generating data points for regression analysis using alternative risk free rates (RFR) may prove challenging. In order to qualify for hedge accounting, entities are required to demonstrate that the hedging relationship is highly effective both at inception and on an ongoing basis.

In practice, hedge effectiveness is usually assessed using a statistical method such as a regression analysis. When LIBOR is retired, the ability to perform the valuation of trades that rely on an alternative RFR for regression analysis will be dependent upon widespread adoption of that RFR, ideally with a very robust market for derivatives of varying tenors.

However, it is possible that not all alternative RFRs will have sufficient transaction volume upon transition. For example, the Secured Overnight Financing Rate (SOFR), the alternative RFR for USD LIBOR, was only published in April 2018 in the US, and SOFR-based derivatives and futures contracts have just a fraction of the trade volume compared to LIBOR, Eurodollar, Treasury and Fed Funds-based derivatives at the moment. Without official historical data, back-testing and historical RFR term rates can't be observed, making it more difficult to prove prospective effectiveness of hedging relationships involving RFR-based derivatives.

Even with recent market developments demonstrating that SOFR and other RFR are becoming more widely adopted—such as the recent issuance of SOFR-related debt by the World Bank and Fannie Mae and CME's pending launch of clearing OTC SOFR-based swaps—the valuation of RFR-based trades still requires a more robust

[4] US GAAP uses the term "probable", whereas IFRS uses the term "highly probable" for purposes of assessing the probability of the forecasted transaction.

[5] In a cash flow hedge of interest rate risk, LIBOR is often referenced in the description of the hedged risk, hedged item, or the hedged forecasted transaction.

market for SOFR-based transactions. The uncertainty around the timing of that development should be taken into consideration when assessing hedge effectiveness.

In addition, regression analysis from an index based on overnight transactions presents a challenge. SOFR, similar to the Sterling Overnight Index Average (SONIA)[6], is currently viewed as a strictly overnight rate, whereas LIBOR provides for different term rate options, from overnight to one-year rates. The timeline for RFR derivative term structures appears to be slow and gradual.

Hedge documentation may also need significant updating to reflect the change in transaction terms. In connection with any changes to the hedge instrument or hedge forecast transaction, there may be a need to evaluate whether the related descriptions should be updated to reflect a change from LIBOR to another reference rate.

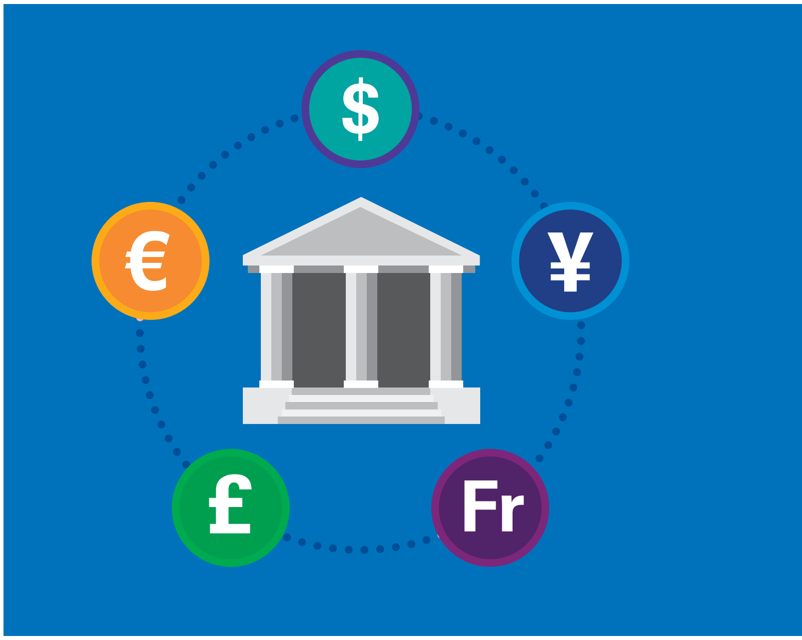
Additionally, in the past, modification of hedge documentation could constitute a hedge de-designation and re-designation event. It remains to be seen whether standard setters will provide any transition relief such that hedge documentation amendments due to LIBOR transition should not cause a hedge de-designation and re-designation event.

The greater the volume of hedges in place, the more operationally burdensome it will be to track and evaluate all hedge documentation. Companies may also need to establish new control processes to ensure that all hedge documentation is evaluated and updated appropriately.

With all of the potential accounting implications, the standard setters are taking action. In October 2018, the FASB issued an Accounting Standard Update[7] to add SOFR as one of the permitted benchmark rates. However, guidance has yet to be provided by either FASB or IASB regarding the transition from LIBOR to another reference rate.

As previously mentioned, the FASB has added a project to assess the breadth of the accounting impact due to the expected LIBOR transition. Any future guidance from the FASB's project may address existing hedging relationships affected by the LIBOR transition, as well as for other areas of accounting such as those discussed below[8].

Similar to the FASB, in June 2018, the IASB also established a research group to monitor further developments regarding LIBOR reforms and to determine whether there are any implications to the existing accounting standards. However, whether the IASB chooses to provide any clarification guidance remains to be seen.



[6] SONIA is the alternative RFR for GBP LIBOR.
[7] Accounting Standards Update 2018-16 – Derivatives and Hedging (Topic 815): Including of the secured overnight financing rate overnight index swap as a benchmark interest rate for hedge accounting purposes.
[8] Meeting of the FASB held on August 29, 2018.

Debt modification

Certain debt agreements may require renegotiation. Today, billions of dollars in outstanding principal debt are indexed to LIBOR. While certain debt agreements contain language specifying that an alternative or fallback rate can be used if LIBOR is unable to be determined, others may not.

For debt agreements without stated fallback provisions, the borrower and creditor will have to negotiate an alternative index. Consequently, the parties will need to perform an assessment to determine whether the modification to the debt agreement results in one of two accounting outcomes: an accounting modification to the existing credit agreement, or an extinguishment of the old debt agreement and the issuance of a new one.

If the debt is determined to be extinguished as a result of the index rate change, there may be unintended gain or loss recognized in earnings. In a case of modification that does not result in de-recognition, under US GAAP the effective interest rate will be reset and accounted for prospectively.

However, additional challenges may arise for IFRS reporters who will need to establish whether the changes in the rate should be accounted for as an update to an effective interest rate, akin to treatment of changes in rate for floating-rate financial instruments[9], or if modification guidance should apply[10].

As previously noted, both the FASB and IASB have projects on their agendas to consider the effects of the LIBOR transition, including debt modification. As such, entities should monitor their progress when considering modifications to debt arrangements.

Discount rate impairment testing, lease accounting and fair valuation

A transition to a new reference rate may change the discount rates used in far-reaching models. Currently, LIBOR is a key component to the discount rates used for many purposes, and a key input in models used in the valuation of various assets and liabilities such as financial instruments, leases, commodity futures, and in impairment testing of non-financial assets (e.g., goodwill).

As such, companies will need to consider how the outputs of the impacted models will change if LIBOR is no longer published, and how that ultimately impacts systems and processes downstream. An extensive analysis can help uncover the affected models and how those models impact different areas within the financial statements.

By no means is this a comprehensive list of accounting considerations, and the LIBOR transition will impact every company differently. However, organizations can use this as a starting point to consider assessment needs, and to better target efforts.

[9] Under IFRS 9, Financial Instruments, the periodic re-estimation of cash flows to reflect movements in market rates of interest will change the effective interest rate of a floating rate financial asset or financial liability.

[10] Pursuant to IFRS 9, if the modification of a financial asset or a financial liability is not accounted for as an extinguishment, then the gross carrying amount of the assets (or amortized cost of the liability) is recalculated and the resulting gains or losses are recognized immediately.

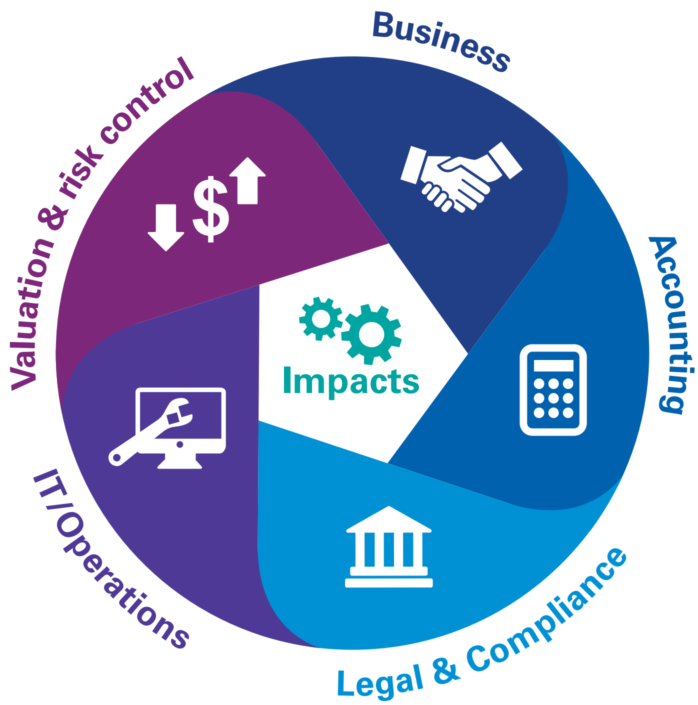
LIBOR transition impact assessment

With the high levels of uncertainty surrounding the forthcoming LIBOR transition, planning ahead can save countless time and resources.

Organizations can get a head start with an inventory of potential areas of impact. One approach is to start with each model leveraging LIBOR and determine its dependencies throughout the organization, from finance and accounting, to business, legal, IT and operations.

Examples of affected elements within areas include:

- Client outreach and communications
- Accounting and other systems
- Risk and valuation models
- Additional disclosures
- Data sets



How we can help

Our team of professionals across accounting advisory, risk analytics, financial management and other functions has worked with companies around the world to plan for and manage countless operational, accounting and financial reporting changes. The transition to an alternative benchmark and away from LIBOR is expected to have significant follow-on accounting impact for many organizations.

We help by assisting companies in their assessment of how wide and deep that impact may be, including effects on financial reporting, regulatory reporting and financial planning and analysis. We also help develop a timeline and path for change that covers accounting policies, process requirements and growth objectives.

Finally, we can continue to work with cross-functional teams within organizations to implement the plans to address the accounting impact and to help maintain compliance and other processes going forward.

Ultimately, we can help organizations meet their goals for a smooth transition to a new benchmark rate, with minimal cost and business disruption. We look forward to helping you successfully navigate this change.

LIBOR transition is going to impact how companies need to approach a number of processes going forward. KPMG can help plan for and manage the many elements of end-to-end LIBOR replacement, including the following:

Governance and oversight. Implementation of policies, procedures and stakeholder roles and responsibilities. Issues and escalation frameworks. Monitoring for remediation.

Strategy. Industry development, involvement and monitoring. Transition timelines for internal products. Pricing and global reference rate impacts.

Scope/impact inventory. Assessment of business units, products, systems and applications, vendors, models and internal functions.

Contract change management. Impact assessment across contract portfolio. Amendment definitions. Amendment execution and compliance tracking.

Modeling remediation. Updates to models and related documentation. Back-testing and validation.

Operations and technology remediation. Reference data systems. New product implementation. Migration of existing contracts and positions.

Client and regulatory communications. Design and deployment of internal communications and trainings. Retail and commercial communication strategies. Call center and relationship manager trainings.

Accounting, tax and internal audit. Determination of exposure to transition value. Impact assessment of transition on areas such as hedge accounting, debt modification, impairment testing and disclosures/reporting requirements, as well as the potential tax impact.

Post-transaction activities. Ongoing monitoring and reporting. Remediation activities.

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