Exposure Draft

Financial Reporting Council

May 2020

FRED 74

Draft amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

Interest rate benchmark reform (Phase 2)

The FRC's purpose is to serve the public interest by setting high standards of corporate governance, reporting and audit and by holding to account those responsible for delivering them. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the competent authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

Financial Reporting Council

May 2020

FRED 74

Draft amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

Interest rate benchmark reform (Phase 2)

Contents

Overview

(i) The FRC's overriding objective in setting accounting standards is to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.

Draft amendments to FRS 102

(ii) Interest rate benchmarks such as the London Interbank Offered Rate (LIBOR) are being reformed, and it is anticipated that LIBOR will not be available after 2021. This has resulted in increased uncertainty about the long-term viability of some interest rate benchmarks. In response to this increased uncertainty, the FRC amended specific hedge accounting requirements in Section 12 *Other Financial Instruments Issues* of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in 2019.

(iii) The amendments in 2019 focussed on financial reporting issues arising before the reform of an interest rate benchmark. Further issues might affect financial reporting during the reform of an interest rate benchmark in respect of modifications to financial instruments, changes to hedging relationships and modifications to leases. This FRED, which represents a second phase of amendments, focusses on these issues.

(iv) This FRED proposes amendments to the accounting requirements in Section 11 *Basic Financial Instruments,* Section 12 *Other Financial Instruments Issues* and Section 20 *Leases* to provide relief to minimise discontinuities in the accounting for financial instruments and leases, minimise reporting costs, assist entities in providing useful information to users of financial statements and avoid unnecessary discontinuation of hedge accounting as agreements are modified in order to transition to alternative benchmark rates. Entities will account for modifications as if they result from periodic re-estimations of cash flows to reflect changes in market rates of interest.

(v) It is proposed that the amendments are effective for accounting periods beginning on or after 1 January 2021, with early application permitted.

Invitation to comment

1 The FRC is requesting comments on FRED 74 by 30 September 2020. The FRC is committed to developing standards based on evidence from consultation with users, preparers and others. Comments are invited in writing on all aspects of the draft standard. In particular, comments are sought in relation to the questions below.

> **Question 1**
>
> Do you agree with the proposed amendments to FRS 102? If not, why not?
>
> **Question 2**
>
> In relation to the Consultation stage impact assessment, do you have any comments on the costs and benefits identified? Please provide evidence to support your views.

2 Information on how to submit comments and the FRC's policy in relation to responses is set out on page 17.

Draft amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

Draft amendments to Section 1 *Scope*

1 The following paragraph sets out the draft amendments to Section 1 *Scope* (inserted text is underlined).

2 Paragraphs 1.24 to 1.27 and the sub-heading before them are inserted as follows:

Interest rate benchmark reform (Phase 2)

1.24 In [month year] amendments were made to this FRS to insert or amend paragraphs 11.2A, 11.2B, 11.20A to 11.20D, 11.49, 11.50, 12.2A, 12.2B, 12.25B, 12.25I to 12.25S, 20.11A and 20.11B, and make other minor consequential amendments. These amendments are effective for accounting periods beginning on or after 1 January 2021. Early application is permitted. If an entity applies these amendments to an accounting period beginning before 1 January 2021 it shall disclose that fact, unless it is a small entity, in which case it is encouraged to disclose that fact.

1.25 On their first-time application, an entity shall apply the amendments set out in paragraph 1.24 retrospectively, in accordance with paragraph 10.12, except as specified in paragraph 1.27.

1.26 In applying the amendments in paragraph 1.24 retrospectively, an entity shall reinstate a discontinued hedging relationship if, and only if, the discontinuation arose solely due to changes required by interest rate benchmark reform and would not have been required if the amendments had been applied at that time.

1.27 An entity is not required to restate prior periods when applying the amendments in paragraph 1.24 retrospectively. If an entity does not restate prior periods, the entity shall apply those amendments in remeasuring the carrying amounts of assets and liabilities as at the beginning of the reporting period in which the amendments are first applied and shall make a corresponding adjustment to the opening balance of retained earnings (or other component of equity, as relevant).

Draft amendments to Section 11 *Basic Financial Instruments*

3 The following paragraphs set out the draft amendments to Section 11 *Basic Financial Instruments* (inserted text is underlined, deleted text is struck through).

4 Paragraph 11.2A is amended and paragraph 11.2B is inserted as follows:

11.2A ~~[Deleted]~~An entity choosing to apply the recognition and measurement provisions of IAS 39, in accordance with paragraph 11.2(b), shall apply the requirements in [draft] paragraphs 6.9.1 to 6.9.6 of IFRS 9 to financial assets and liabilities that are modified, or have existing contractual terms activated that change the basis for determining the contractual cash flows, as a result of interest rate benchmark reform (as defined in paragraph 102B of IAS 39).

11.2B For the purposes of applying [draft] paragraphs 6.9.3 to 6.9.6 of IFRS 9, the references to paragraph B5.4.5 of IFRS 9 shall be read as referring to paragraph AG7 of IAS 39. References to paragraphs 5.4.3 and B5.4.6 of IFRS 9 shall be read as referring to paragraph AG8 of IAS 39.

5 Paragraphs 11.20A to 11.20D and the sub-heading before them are inserted after the example in paragraph 11.20 as follows:

Temporary exceptions arising from interest rate benchmark reform

11.20A Paragraphs 11.20B to 11.20D apply to all financial assets and liabilities:

(a) that are modified; or

(b) have existing contractual terms activated that change the basis for determining the contractual cash flows

as a result of interest rate benchmark reform and only to such financial assets and liabilities. For the purposes of applying these paragraphs only, a financial asset or liability is to be considered modified if the basis for determining the contractual cash flows is changed even if the contractual terms are not amended.

11.20B As a practical expedient, an entity shall apply paragraph 11.19 to account for a modification that is required by interest rate benchmark reform, as if the modification was a periodic re-estimation of cash flows of a variable rate financial instrument to reflect a change in a market rate of interest. This practical expedient applies only to the extent that the modification is:

(a) required as a direct consequence of interest rate benchmark reform; and

(b) the new basis for determining the contractual cash flows is economically equivalent to the basis immediately preceding the modification.

11.20C An entity shall also apply the practical expedient in paragraph 11.20B if:

(a) the entity revises its estimates of payments and receipts because an existing contractual term is activated that changes the basis for determining the contractual cash flows (for example, an existing fallback clause is triggered);

(b) that activation of the existing contractual term is required as a direct consequence of interest rate benchmark reform; and

(c) the new basis for determining the contractual cash flows is economically equivalent to the basis immediately preceding the activation.

11.20D If there are changes to the basis for determining the contractual cash flows of a financial asset or liability in addition to changes required by interest rate benchmark reform, an entity shall first apply the practical expedient in paragraph 11.20B to the changes required by interest rate benchmark reform. The entity shall then apply the applicable requirements of this FRS to the additional changes. If those additional changes result in the de-recognition of the financial asset or liability, then the de-recognition requirements apply (for example, the requirements of paragraph 11.37 in respect of the de-recognition of a substantially modified financial liability).

6 Paragraphs 11.49 and 11.50, and the sub-heading before them are inserted as follows:

Interest rate benchmark reform

11.49 An entity shall disclose information on the nature and extent of risks arising from interest rate benchmark reform to which the entity is exposed, how the entity manages those risks and the entity's progress in completing the transition from interest rate benchmarks to alternative benchmark rates.

11.50 When an entity has taken advantage of the practical expedients in paragraphs 11.20B and 11.20C, it shall disclose that fact. It shall also consider whether any further disclosure is necessary, for example in accordance with paragraphs 8.6 and 8.7.

Draft amendments to Section 12 *Other Financial Instruments Issues*

7 The following paragraphs set out the draft amendments to Section 12 *Other Financial Instruments Issues* (inserted text is underlined, deleted text is struck through).

8 Paragraph 12.2A is amended and paragraph 12.2B is inserted as follows:

12.2A ~~[Deleted]~~An entity choosing to apply the recognition and measurement provisions of IAS 39, in accordance with paragraph 12.2(b), shall apply the requirements in [draft] paragraphs 6.9.1 to 6.9.6 of IFRS 9 to financial assets and liabilities that are modified, or have existing contractual terms activated that change the basis for determining the contractual cash flows, as a result of interest rate benchmark reform (as defined in paragraph 102B of IAS 39).

12.2B For the purposes of applying [draft] paragraphs 6.9.3 to 6.9.6 of IFRS 9, the references to paragraph B5.4.5 of IFRS 9 shall be read as referring to paragraph AG7 of IAS 39. References to paragraphs 5.4.3 and B5.4.6 of IFRS 9 shall be read as referring to paragraph AG8 of IAS 39.

9 Paragraph 12.25B is amended as follows:

12.25B Paragraphs 12.25C to 12.25~~H~~S only apply to hedging relationships of interest rate risk that are affected by interest rate benchmark reform. A hedging relationship is affected by interest rate benchmark reform if the reform gives rise to uncertainties about the timing and/or the amount of the interest rate benchmark-based cash flows of the hedged item and/or the hedging instrument.

10 Paragraphs 12.25I to 12.25S are inserted as follows:

12.25I As and when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows, an entity shall amend the documentation of the hedging relationship previously prepared in accordance with paragraph 12.18(d). The documentation shall be amended only to make one or more of the following changes:

(a) identifying an alternative benchmark rate (contractually or non-contractually specified) as a hedged risk;

(b) amending the description of a hedged item so that it refers to an alternative benchmark rate; or

(c) amending the description of the hedging instrument so that it refers to an alternative benchmark rate.

12.25J If changes are made to the financial asset and financial liability identified in a hedging relationship in addition to changes required by interest rate benchmark reform (see paragraphs 11.20B and 11.20C) or as documented in accordance with paragraph 12.25I, an entity shall first apply the relevant requirements of this section to determine if those additional changes result in the discontinuation of the hedge accounting.

12.25K For the avoidance of doubt, amending the documentation of a hedging relationship in accordance with paragraph 12.25I does not constitute the discontinuation of a hedging relationship nor the documentation of a new hedging relationship.

12.25L Applying paragraph 12.25I, depending on when the uncertainty arising from interest rate benchmark reform is resolved, an entity may amend the documentation of different hedging relationships at different times, or may amend the documentation of a particular hedging relationship more than once.

When, and only when, such a change is made to the hedging documentation, an entity shall apply paragraphs 12.25M to 12.25R to the extent relevant (ie to the extent that the alternative benchmark rates are applied). Paragraphs 12.25M to 12.25S provide exceptions only to the requirements specified in those paragraphs. An entity shall apply all other hedge accounting requirements in this standard to hedging relationships that are affected by interest rate benchmark reform.

Fair value hedges

12.25M In applying paragraph 12.20 to account for a fair value hedge at the time the hedge documentation is amended in accordance with paragraph 12.25I, an entity shall:

(a) remeasure the hedging instrument using the alternative benchmark rate and recognise a corresponding gain or loss in profit or loss; and

(b) remeasure the carrying amount of the hedged item using the alternative benchmark rate identified as the hedged risk and recognise a corresponding gain or loss in profit or loss.

Cash flow hedges

12.25N In applying paragraph 12.23 to account for a cash flow hedge at the time the hedge documentation is amended in accordance with paragraph 12.25I, the cash flow hedge reserve shall be remeasured to the lower of:

(a) the cumulative gain or loss on the hedging instrument calculated using the alternative benchmark rate; and

(b) the cumulative change in the fair value of the hedged item calculated using the alternative benchmark rate.

12.25O When there is a change in the basis for determining the contractual cash flows of a financial asset or financial liability that was previously identified as the hedged item in a discontinued hedging relationship, any amount accumulated in the cash flow hedge reserve and retained in accordance with paragraph 12.25A shall be remeasured using the alternative benchmark rate on which the contractual cash flows will be based.

Groups of items

12.25P In applying paragraph 12.25I to groups of items identified as hedged items in a hedging relationship, the entity shall allocate the hedged items to sub-groups based on the benchmark rate being hedged, and identify the benchmark rate for each sub-group as the hedged risk. The hedging documentation would then be amended for each sub-group as and when the uncertainty arising from interest rate benchmark reform is no longer present for that sub-group.

Designation of risk components

12.25Q If an alternative benchmark rate is documented as a non-contractually specified risk component and that rate is not separately identifiable at the date of documentation (for the purposes of meeting the requirements in paragraph 12.16C), it shall be deemed to have met that requirement at that date, if and only if, the entity reasonably expects the alternative benchmark rate will be separately identifiable within 24 months of that date.

12.25R If subsequently, the entity reasonably expects that the alternative benchmark rate will not be separately identifiable within 24 months of the documentation date, the entity will cease applying paragraph 12.25Q and discontinue hedge accounting prospectively from the date of reassessment.

12.25S Paragraphs 12.25Q and 12.25R shall also be applied to new hedging relationships in which an alternative benchmark rate is documented as a non-contractually specified risk component applying paragraph 12.16C when that component is not separately identifiable at the date of documentation due to interest rate benchmark reform.

11 Paragraph 12.25I is renumbered as paragraph 12.25T.

Draft amendments to Section 20 *Leases*

12 The following paragraphs set out the draft amendments to Section 20 *Leases* (inserted text is underlined).

13 Paragraphs 20.11A and 20.11B are inserted as follows:

20.11A Paragraph 20.11B applies to all leases that have been modified as a result of interest rate benchmark reform and only to such leases. For the purposes of applying this paragraph only, a lease is to be considered modified if the basis for determining the contractual cash flows is changed even if the contractual terms are not amended.

20.11B An entity shall apply the practical expedient in paragraph 11.20B to account for a modification to a lease that is required by interest rate benchmark reform, as if the modification was a periodic re-estimation of cash flows of a variable rate financial instrument to reflect a change in a market rate of interest. This practical expedient applies only to the extent that the modification is:

(a) required as a direct consequence of interest rate benchmark reform; and

(b) the new basis for determining the contractual cash flows is economically equivalent to the basis immediately preceding the modification.

Basis for Conclusions
FRED 74 *Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Interest rate benchmark reform (Phase 2)*

This Basis for Conclusions accompanies, but is not part of, this Financial Reporting Exposure Draft and summarises the main issues considered by the Financial Reporting Council (FRC) in developing FRED 74 Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Interest rate benchmark reform (Phase 2).

When these proposals are finalised, the Basis for Conclusions accompanying FRS 102 will be updated.

Objective

1 In developing financial reporting standards, the overriding objective of the FRC is to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.

2 In achieving this objective, the FRC aims to provide succinct financial reporting standards that:

(a) have consistency with global accounting standards through the application of an IFRS-based solution unless an alternative clearly better meets the overriding objective;

(b) balance improvement, through reflecting up-to-date thinking and developments in the way businesses operate and the transactions they undertake, with stability;

(c) balance consistent principles for accounting by all UK and Republic of Ireland entities with proportionate and practical solutions, based on size, complexity, public interest and users' information needs;

(d) promote efficiency within groups; and

(e) are cost-effective to apply.

Interest rate benchmark reform

3 For the purposes of these proposed amendments, interest rate benchmark reform refers to the market-wide replacement of an existing interest rate benchmark with an alternative interest rate that results from the recommendations set out in the Financial Stability Board's July 2014 report *Reforming Major Interest Rate Benchmarks*.

4 Interest rate benchmarks such as the London Interbank Offered Rate (LIBOR) are being reformed, and it is anticipated that LIBOR will not be available after 2021. This has resulted in increased uncertainty about the long-term viability of some interest rate benchmarks. In response to this increased uncertainty, the FRC amended specific hedge accounting requirements in Section 12 *Other Financial Instruments Issues* of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in 2019.

5 The amendments in 2019 focussed on financial reporting issues arising before the reform of an interest rate benchmark. Further issues might affect financial reporting during the reform of an interest rate benchmark in respect of modifications to financial instruments, changes to hedging relationships and modifications to leases. This FRED, which represents a second phase of amendments, focusses on these issues.

6 This FRED proposes amendments to the accounting requirements in Section 11 *Basic Financial Instruments,* Section 12 *Other Financial Instruments Issues* and Section 20 *Leases* to provide relief to minimise discontinuities in the accounting for financial instruments and leases, minimise reporting costs, assist entities in providing useful information to users of financial statements and avoid unnecessary discontinuation of hedge accounting as agreements are modified in order to transition to alternative benchmark rates. Entities will account for modifications as if they result from periodic re-estimations of cash flows to reflect changes in market rates of interest.

7 Interest rate benchmark reform will affect some entities applying FRS 102. The IASB is proposing to amend its standards for interest rate benchmark reform, and the proposals are based on ED/2020/1 *Interest Rate Benchmark Reform—Phase 2: Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16* issued by the IASB in April 2020, which was open for comment until 25 May 2020. The requirements, when accounting for modifications to financial instruments, of FRS 102, set out in Section 11, and the hedge accounting requirements, set out in Section 12, are similar to those in IFRS 9 *Financial Instruments.* Furthermore, FRS 102 permits entities an accounting policy choice to apply the recognition and measurement requirements of IFRS 9 or IAS 39.

8 Therefore, the FRC has considered how FRS 102 might be amended to provide similar relief. In considering the issue, the FRC noted that interest rate benchmark reform is an international and systemic issue and it did not want to develop a financial reporting solution in isolation from other relevant developments. The IASB's ED/2020/1 was identified as a suitable basis for the development of similar amendments to FRS 102, which include simplifications and changes to reflect the scope of FRS 102. These proposals mean that relief is available to all entities applying FRS 102, regardless of their accounting policy choice in relation to financial instruments. The IASB is expected to finalise the amendments during 2020, making them applicable for accounting periods beginning on or after 1 January 2021. In order to make similar relief available to entities applying FRS 102 within a consistent timeframe, the FRC decided to consult on amendments similar to the IASB's proposals, rather than waiting for the final amendments to IFRSs.

9 As a result, when considering respondents' feedback to this FRED, the FRC will also consider how the IASB finalised its proposals and may make further changes to the proposals to reflect the final amendments issued by the IASB.

Effective date

10 The proposed effective date is accounting periods beginning on or after 1 January 2021. Although the IASB is expected to finalise its amendments during 2020 it may not be possible to finalise the amendments to FRS 102 until early 2021, but this will not change the effective date.

Consultation stage impact assessment

Introduction

1 The Financial Reporting Council (FRC) is committed to a proportionate approach to the use of its powers, making effective use of impact assessments and having regard to the impact of regulation on small enterprises.

Draft amendments to FRS 102

2 These proposals will affect all entities that are parties to financial instruments or lease agreements which are affected by the reform of interest rate benchmarks.

3 The IASB has proposed amendments to IFRS 9 *Financial Instruments,* IAS 39 *Financial Instruments: Recognition and Measurement* and other standards to provide reliefs during the period of reform. The recognition and measurement requirements of IFRS 9 are available as an accounting policy choice to entities applying FRS 102, and the underlying need for reliefs could apply equally to entities applying FRS 102. Therefore, the FRC decided to make similar reliefs available to all entities applying FRS 102.

4 The proposals will minimise the financial reporting costs of accounting for changes to financial instruments and leases arising as a result of interest rate benchmark reform. Entities will be exempt from the requirements to assess whether such modifications are significant or consider if it is necessary to de-recognise existing financial assets and liabilities and replace them with new ones. They will also avoid the discontinuation of hedge accounting solely due to changes to hedge documentation arising from changes in benchmark rates. These reliefs will be of benefit to users of financial statements, as the de-recognition and recognition of financial assets and liabilities or the early discontinuation of hedge accounting would not provide useful information to users.

Conclusion

5 Overall, the FRC believes that the draft amendments to FRS 102 will have a positive impact on financial reporting.

This draft is issued by the Financial Reporting Council for comment. It should be noted that the draft may be modified in the light of comments received before being issued in final form.

For ease of handling, we prefer comments to be sent by e-mail to:

ukfrs@frc.org.uk

Comments may also be sent in hard copy to:

Jenny Carter
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

Comments should be despatched so as to be received no later than 30 September 2020. If you have sent a copy of your response electronically, there is no need to send an additional hard copy.

The FRC's policy is to publish on its website all responses to formal consultations issued by the FRC unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. The FRC does not edit personal information (such as telephone numbers or postal or e-mail addresses) from submissions; therefore, only information that you wish to be published should be submitted.

The FRC aims to publish responses within 10 working days of receipt.

The FRC will publish a summary of the consultation responses, either as part of, or alongside, its final decision.

FRC

Further copies, £17.00 (post-free) can be obtained from

FRC Publications
Lexis House
30 Farringdon Street
London
EC4A 4HH

Tel: **0845 370 1234**
Email: **customer.services@lexisnexis.co.uk**
Or order online at: **www.frcpublications.com**

ISBN 978-0-7545-5799-9

9 780754 557999