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A Farewell to LIBOR is on the Horizon – What This Might Mean for You This Year

by

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Background

LIBOR (the London Interbank Offered Rate) was once the gold standard for measuring market interest rates. After determining that the rate no longer was reliable, banking regulators have encouraged banks stop referencing that rate in new contracts with customers and other parties (e.g., loans, debt securities, and derivative instruments) and have mandated cessation of its use in new contracts by no later than the end of this year. The published rate will begin to be phased out after this year and will be discontinued entirely in June 2023. Presently, the leading index to replace LIBOR in the U.S. is SOFR (the Secured Overnight Financing Rate).

While this change has a huge impact on financial institutions, nonfinancial institutions are not completely immune. Many companies have loans, debt securities, investments, and derivative instruments (e.g., interest rate swaps) that are currently indexed to LIBOR. The counterparty financial institutions, and in some cases companies themselves, will need to issue new contracts with an alternative rate index or modify existing contracts to replace LIBOR if the loan or agreement does not already contain provisions for using an alternative rate if LIBOR is no longer available.

Accounting Implications – Existing Contracts

As contracts are modified to replace LIBOR with another interest rate index, questions may arise regarding the accounting for such modifications. For example, does the modification need to be recorded as an extinguishment of the original contract and the issuance or acquisition of a new replacement contract, or can the modification be recorded prospectively for the original contract?

Fortunately, the FASB has tried to provide some relief in the form of Accounting Standards Update (ASU) Nos. 2020-04 and 2021-01, *Reference Rate Reform (Topic 848)*.

The amendments in this Update apply to contract modifications that replace a reference rate affected by reference rate reform (including rates referenced in fallback provisions) and contemporaneous modifications of other contract terms related to the replacement of the reference rate (including contract modifications to add or change fallback provisions).

ASU 2020-04 provided the following optional expedients for applying the requirements of certain Topics or Industry Subtopics in the Codification are permitted for contracts that are modified because of reference rate reform and that meet certain scope guidance:

1. Modifications of contracts within the scope of Topics 310, *Receivables*, and 470, *Debt*, should be accounted for by prospectively adjusting the effective interest rate.

2. Modifications of contracts within the scope of Topics 840 and 842, *Leases*, should be accounted for as a continuation of the existing contracts with no reassessments of the lease classification and the discount rate (for example, the incremental borrowing rate) or remeasurements of lease payments that otherwise would be required under those Topics for modifications not accounted for as separate contracts.

3. Modifications of contracts do not require an entity to reassess its original conclusion about whether that contract contains an embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract under Subtopic 815-15, *Derivatives and Hedging—Embedded Derivatives*.

ASU 2021-01 clarified the scope of contracts covered by Topic 848. Specifically, it made the following clarifications:

- Clarified that the contract modification relief may be applied to contracts that meet the scope of paragraph 848-10-15-3 and are affected by the discounting transition (paragraph 848-20-15-2).
- Added derivative instruments that meet the scope of paragraph 848-10-15-3A to the scope of derivative instruments eligible for contract modification relief in paragraph 848-20-35-4 (paragraph 848-20-15-2A).
- Consequential amendments related to the clarification that contract modification relief may be applied to contracts that meet the scope of paragraph 848-10-15-3 and are affected by the discounting transition (paragraphs 848-20-15-3 and 848-20-15-5).

Banks and other financial institutions are beginning to issue new contracts (e.g., loans and derivatives) with an alternative rate index or language that allows substitution of a different index if LIBOR no longer is available. Existing contracts also may be modified, as the published LIBOR rate has been deemed vulnerable to manipulation. As companies are the counterparties to these contracts, they will need to review new or modified contracts and determine whether they fall within the scope of ASU 2020-04 (Topic 848).

If a rate change from LIBOR does not qualify as change that is within the scope of Topic 848, an assessment needs to be made as to whether the change in terms should be accounted for as a modification or the termination of the original contract and the acquisition of a new contract. Generally, the accounting for a contract modification will differ from a termination of the original contract and acquisition of a new contract.

Accounting Implications – New Contracts

Some new loan agreements have added clauses that permit the interest index to change from LIBOR to another index in anticipation that LIBOR no longer will be available. Companies will need to assess those clauses to see if they represent embedded derivatives that require bifurcation and separate accounting at fair value. In many cases, such an embedded feature will be considered clearly and closely related to the loan, which would preclude separate accounting. However, if there is a substantial leverage factor involved (e.g., discount or premium), that may not be the case.

Closing

Companies will want to stay vigilante and carefully evaluate modifications to existing contracts and embedded features in new contracts as the world says farewell to LIBOR.

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Our extensive knowledge of US GAAP, ICFR and SEC reporting skills has given us the ability to assist our clients with transactions that are not only multifaceted, but the capability to implement new or complex accounting standards. We have over 130 partners and employees in our Los Angeles, Orange County, San Diego, and New York City offices. Many of our clients are developed from direct referrals from the Big 4 accounting firms, speaking to the level of quality services we provide.

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