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STAFF PAPER

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Project	IBOR Reform and its Effects on Financial Reporting—Phase 2		
Paper topic	Disclosures		
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Purpose of this paper

1. The purpose of this paper is to analyse whether any additional disclosure requirements need to accompany the tentative decisions the Board has made during Phase 2 of the IBOR Reform and its Effects on Financial Reporting project and if so, what disclosures would provide users of financial statements with useful information about the effects of the transition to alternative benchmark rates on an entity's financial statements.
2. At this meeting, the staff will ask the Board to make a decision on the proposed disclosures for Phase 2 of the project as set out in this paper.

Structure of this paper

3. This paper is structured as follows:
   (a) Background (paragraphs 4-6)
   (b) Is there a need for disclosures in Phase 2? (paragraphs 7-16);
   (c) Objective and disclosures (paragraphs 17-26);
   (d) Staff recommendation (paragraphs 27-28);
   (e) Questions for the Board (page 11).

Background

4. In September 2019 the Board discussed the scope of the issues to be considered in this project and the proposed order in which these issues should be discussed (project plan).

5. At the October and December 2019 meetings, the Board tentatively decided to make amendments to IFRS 9 *Financial Instruments* for specific aspects of classification and measurement of financial instruments and to IFRS 9 and IAS 39 *Financial Instruments: Recognition and Measurement* for specific aspects of hedge accounting. These tentative decisions are described in AP14 *Cover paper and summary of tentative decisions to date* for this meeting. In addition, AP14A *End of relief* and AP14B *Other IFRS Standards* for this meeting set out further staff recommendations on the end of Phase 1 relief and the potential impact of IBOR reform on other IFRS Standards for the Board to discuss.

6. According to the project plan, the next key area for discussion is the consideration of whether any additional disclosure requirements need to accompany the Board's tentative decisions in this phase of the project.

Is there a need for disclosures in Phase 2?

7. Phase 2 of the IBOR Reform and its Effects on Financial Reporting project addresses issues that might affect financial reporting when an existing interest rate benchmark is reformed including replacement with an alternative benchmark rate (replacement issues). The objectives of the Board's tentative decisions in this project are to provide useful information to users of financial statements about the effects of the transition to alternative benchmark rates on an entity's financial statements and support preparers in applying the requirements of IFRS Standards during IBOR reform.

8. The staff note that the transition from IBORs to alternative benchmark rates is likely to have broader implications on the entity's business, financial statements and risks it is exposed to and how it manages those risks. Examples of such implications include but are not limited to:

(a) Risks arising from the existing fallback language for financial instruments, or lack thereof. For example, when fallback clauses in existing contracts are not sufficiently precise, giving rise to potential disagreement between contractual parties on the interest rate to be applied. Lack of, or ineffective, fallback clauses for contracts means a bilateral renegotiation is needed which could affect the performance of the contract. Given the different transitional stages for different jurisdictions, agreeing on the alternative benchmark rates may be challenging. Some contracts could revert to fixed interest rates as a result of fallback clauses or lack thereof.

(b) Determining the alternative benchmark rates that will replace IBORs including the potential modifications to financial instruments necessary to reflect the different characteristics of an alternative benchmark rate compared to IBORs. Considerations include lack of term rates given alternative benchmark rates are predominantly overnight rates, determining the appropriate spread adjustment to arrive at an economically equivalent rate or any other adjustment.

(c) Other affected areas could include entity's risk management strategy, processes and information systems. Entities would need to evaluate the potential implications on these areas including the new risks that may arise associated with the alternative benchmark rates.

9. It will therefore be important for users of financial statements to be provided with information about the extent to which IBOR reform has resulted in changes to an entity's business, the nature of the risks associated with this reform that the entity is exposed and how the entity is managing the process to transition to alternative benchmark rates.

10. In assessing whether additional disclosure requirements are needed to provide useful information to users of financial statements, the staff considered the following:

(a) the extent to which current presentation and disclosure requirements would provide information about the effect of IBOR reform on an entity's financial statements;

(b) the information needed by users of financial statements to enable them to understand the effects of the transition to alternative benchmark rates on an entity's financial statements;

(c) the incremental costs for preparers to disclose additional information and how that balances with the benefits of the relief that the Board is proposing to provide; and

(d) the potential interaction with disclosures that are required as part of the Phase 1 amendments.

The extent to which information is provided by current presentation and disclosure requirements

11. In assessing the extent to which current presentation and disclosure requirements will provide useful information as described in paragraph 10(a) of this agenda paper, the staff considered the following requirements in IFRS 7 *Financial Instruments: Disclosures*:

(a) Paragraphs 20-20A include requirements for an entity to disclose gains or losses on financial assets or financial liabilities recognised in the statement of comprehensive income, including the gain or loss arising from the derecognition of financial assets measured at amortised cost and the reasons for derecognising those financial assets.

(b) Paragraphs 21B–24F contain disclosure requirements for those risk exposures that an entity hedges and for which it elects to apply hedge accounting.

(c) Paragraphs 33-42 require entities to provide qualitative and quantitative disclosures that enable users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period. These disclosures focus on the risks that arise from financial instruments and how they have been managed.

(d) Paragraph 35J requires disclosures to enable users of financial statements to understand the nature and the effect of modifications of contractual cash flows on financial assets that have not resulted in derecognition and the effect of such modifications on the measurement of expected credit losses.

12. In the absence of any relief provided by the Board to support entities in applying the requirements of IFRS Standards during IBOR reform, information about the effects of the reform would have been provided through these requirements. However, the staff observed that the resulting accounting outcomes from the Board's tentative decisions to date are such that the modifications to contractual cash flows that are (a) required as a direct consequence of IBOR reform and (b) done on an economically equivalent basis (collectively referred to as 'modifications directly required by IBOR reform') including any consequential changes to hedging relationships and hedge documentation, would not result in a gain or loss being recognised in the entity's financial statements. Consequently, information about the effects of IBOR reform on the entity's financial position and performance resulting from transitioning to alternative benchmark rates will not be captured by these requirements.

13. In light of this accounting outcome, the staff consider that in absence of additional disclosure requirements proposed as part of this phase of the project, users of financial statements may not be provided with useful information about the effects of IBOR reform on an entity's financial statements.

What are the key messages from users?

14. For the purpose of the assessment described in paragraph 10(b) of this agenda paper, the staff engaged with users of financial statements including the UK Corporate Reporting Users Forum (CRUF UK) to obtain their views on the need for, and type of, information about the effects of the transition to alternative benchmark rates on an entity's financial statements. The key messages heard include:

    (a) as the scope of the Board's tentative decisions only include those modifications directly required by IBOR reform, users of financial statements want to understand how entities defined or determined which modifications were directly required by IBOR reform and how they have distinguished those modifications from other concurrent modifications, and how the entity determined the economically equivalent rate.

(b) users of financial statements are supportive of the Board's tentative decisions on classification and measurement, and hedge accounting for modifications that are directly required by IBOR reform. Therefore, they accept that only for those modifications (and changes to hedging relationships and hedge documentation necessary to reflect those modifications) no resulting gain or loss will be recognised in the financial statements.

(c) users of financial statements highlighted the need for information about the nature and extent of new risks that the entity is exposed to as a result of IBOR reform and what are the alternative benchmark rates that the entity is transitioning to.

(d) as different jurisdictions are in different stages of the reform, the periods directly affected by IBOR reform may span over several reporting periods and therefore, users of financial statements want to understand an entity's progress made in transitioning to alternative benchmark rates including information about the entity's financial assets and liabilities that are still referenced to IBORs subject to the reform and the entity's expectations about when transition will be completed. For example, they want entities to disclose information about contracts with maturity beyond 2021[1] which still reference London Interbank Offered Rate (LIBOR).

(e) users of financial statements would also like to understand any significant changes to an entity's risk management strategy as a result of IBOR reform.

Costs and benefits of additional disclosures

15. The staff also considered the concerns expressed by preparers, both as part of their feedback on the disclosure requirements proposed for Phase 1 in the May 2019 Exposure Draft and as part of our research and outreach for Phase 2—that is, that the disclosure requirements about the effects of IBOR reform on an entity's financial statements, including the level of granularity required, should not negate the benefit of any potential relief provided by the Board. In particular, they are concerned that the

[1] The Financial Conduct Authority has secured panel bank support to sustain LIBOR until the end of 2021. Beyond this date the publication of LIBOR is not guaranteed.

cost of providing substantial quantitative information about the effect of applying the relief provided by the Board on the entity's financial statements is likely to outweigh the benefits of applying that relief.

Potential interaction with Phase 1 disclosures

16. Due to the nature of IBOR reform and the time needed to complete the transition to alternative benchmark rates, the staff acknowledge that there could be situations in which an entity would be required to provide both the disclosures required by Phase 1 and Phase 2 at the same time. This is because, the Phase 1 disclosures focus on hedging relationships affected by the uncertainties arising from IBOR reform to which an entity applies the exceptions provided as part of Phase 1 amendments, whereas the potential Phase 2 disclosures discussed in this agenda paper will have a broader scope that focusses on the replacement issues affecting financial instruments in general.

Objective and disclosures

17. Based on the considerations described in paragraphs 7–16 of this agenda paper, the staff is of the view that additional disclosure requirements should be included as part of the Phase 2 proposed amendments. As one of the objectives of Phase 2 is to provide useful information to users of financial statements about the effects of the transition to alternative benchmark rates on an entity's financial statements, the additional disclosures required in Phase 2 should enable users of financial statements to understand:

    (a) the nature and extent of risks arising from IBOR reform to which the entity is exposed to, and how the entity manages those risks; and

    (b) the entity's progress in transitioning from IBORs to alternative benchmark rates, and how the entity is managing this transition.

18. To achieve this objective, an entity would disclose information about:

    (a) how it is managing the transition from IBORs to alternative benchmark rates, and the status/progress made at the reporting date;

    (b) the carrying amount of financial assets and financial liabilities, including the nominal amount of the derivatives, that continue to reference interest rate benchmarks subject to the reform, disaggregated by significant interest rate benchmark;

(c) for each significant alternative benchmark rate that the entity is exposed to, an explanation of how the entity determined the base rate and relevant adjustments to the rate, to assess whether the modifications to contractual cash flows were required as a direct consequence of IBOR reform and have been done on an economically equivalent basis; and

(d) the extent to which IBOR reform has resulted in changes to an entity's risk management strategy and how the entity is managing those risks.

19. The staff note that, IFRS 7 already requires entities to consider how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation, and whether users of financial statements need additional explanations to evaluate the information disclosed. Furthermore, if any entity is of the view that the disclosures provided in accordance with the specific requirements are insufficient to meet the stated objective, additional information that is necessary to meet that objective must be disclosed.[2]

20. Accordingly, the staff would expect that the extent of information disclosed would be proportionate to the extent that the entity's financial statements are affected by IBOR reform. For example, the extent of information disclosed by a bank with large exposure to financial instruments affected by IBOR reform will be greater compared to a corporate entity with limited financial instruments that are affected.

21. Furthermore, given the potential co-existence of Phase 1 and Phase 2 disclosure requirements, to the extent these requirements overlap, entities only need to disclose incremental information required by Phase 2 disclosures, ie information that has not already been provided to meet Phase 1 disclosure requirements. Entities are not required to duplicate information that is already disclosed elsewhere.

22. The staff also note that given the scope of Board's tentative decisions is aimed at modifications directly required by IBOR reform—that includes the qualifying criteria for modifications to the interest rate benchmark to be done on an economically equivalent basis, an entity only making those changes is not expected to have

[2] For example, see paragraphs 21D, 35D, B3 and B39 of IFRS 7.

significant effects resulting from IBOR reform in its financial statements. Therefore, there is no loss of useful information to the users of financial statements by not requiring more quantitative information to be disclosed.

23. However, when an entity is doing modifications that fall outside the scope of the Board's tentative decisions, ie when modifications are not done on an economically equivalent basis or when other modifications, not directly required by the reform are done concurrently, this could result in significant effects on the entity's financial statements. In these situations, entities are required to apply the current IFRS requirements (including those summarised in paragraph 11 of this agenda paper) and hence useful information will be provided to users of the financial statements (eg a gain or loss on derecognition when the entity concludes that the financial instrument has been substantially modified).

24. Acknowledging that the disclosures in paragraph 18 of this agenda paper would provide useful information about the nature and extent of risks and the overall effect of the transition to alternative benchmark rates on the reporting entity, the staff also considered whether in order to meet the objective in paragraph 17 of this agenda paper, any additional disclosures are needed, ie information about the specific effects of IBOR reform on classification and measurement of financial instruments, hedge accounting and other IFRSs.

25. However, the staff noted that this would mean entities will have to produce information that may not be available otherwise. For example, if the Board required the disclosure of the gain or loss that would have resulted from the modification to replace the interest rate benchmark with an alternative benchmark rate in the absence of the proposed practical expedient, it would require entities to maintain dual accounting (ie with and without applying the Board's tentative decisions) therefore, negating the benefit of the relief provided by the Board through the practical expedient.

26. On balance, the staff do not consider that the benefits to users of financial statements of introducing such disclosure requirements about what the effects of IBOR reform would have been on the classification and measurement of financial instruments, hedge accounting and other IFRSs in the absence of any relief proposed by the Board, would outweigh the costs to preparers in providing that information.

Staff recommendation

27. Based on the research, outreach and analysis as presented in this paper, the staff recommend that IFRS 7 be amended to require entities to provide disclosures that enable users of financial statements to understand:

    (a) the nature and extent of risks arising from IBOR reform to which the entity is exposed to, and how the entity manages those risks; and

    (b) the entity's progress in transitioning from IBORs to alternative benchmark rates, and how the entity is managing this transition.

28. To achieve this objective, an entity would disclose information about:

    (a) how it is managing the transition from IBORs to alternative benchmark rates, and the status/progress made at the reporting date;

    (b) the carrying amount of financial assets and financial liabilities, including the nominal amount of the derivatives, that continue to reference interest rate benchmarks subject to the reform, disaggregated by significant interest rate benchmark;

    (c) for each significant alternative benchmark rate that the entity is exposed to, an explanation of how the entity determined the base rate and relevant adjustments to the rate, to assess whether the modifications to contractual cash flows were required as a direct consequence of IBOR reform and have been done on an economically equivalent basis; and

    (d) the extent to which IBOR reform has resulted in changes to an entity's risk management strategy and how the entity is managing those risks.

Questions for the Board

Questions for the Board
1. Does the Board agree with the staff recommendation on the objective of disclosures as described in paragraph 27 of this agenda paper? 2. If the Board agrees with the recommended objective, does the Board agree that disclosures should provide the information described in paragraph 28 of this agenda paper?