North Carolina
Office of the State Controller

Financial Reporting Update

GASB 93 Effective for Fiscal Year 2021 Except Paragraphs 11b, 13, and 14, which are Effective for FY 2022

February 25, 2021

In March 2020, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 93, *Replacement of Interbank Offered Rates* (GASB 93). Governments have entered into agreements in which variable payments made or received depend on an interbank offered rate (IBOR). The London Interbank Offered Rate (LIBOR) is the most often used. As a result of global reference rate reform, LIBOR is expected to no longer exist after December 31, 2021. This will cause governments to amend or replace financial instruments to replace LIBOR with other reference rates by either changing the reference rate or adding or changing fallback provisions related to the reference rate.

GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, (GASB 53) requires a government to terminate hedge accounting when it renegotiates or amends a critical term of a hedging derivative instrument, such as the reference rate of a hedging derivative instrument's variable payment. The termination of hedge accounting results in the immediate recognition of the related deferred outflows of resources or deferred inflows of resources as a component of investment income.

In accordance with GASB Statement No. 87, Leases, (GASB 87) replacement of the rate on which variable payments depend in a lease contract would require a government to apply the provisions for lease modifications, including remeasurement of the lease liability or lease receivable.

GASB 93 addresses these and other accounting and financial reporting implications that result from the replacement of an IBOR, such as LIBOR. GASB 93 establishes accounting and financial reporting requirements related to the replacement of IBORs in hedging derivative instruments and leases. It also identifies appropriate benchmark interest rates for certain hedging derivative instruments.

Hedging Derivative Instruments

Renegotiating or amending a critical term of a hedging derivative instrument generally requires termination of hedge accounting. GASB 93 provides exceptions to the hedge accounting termination provisions when an IBOR is replaced as the reference rate of the hedging derivative instrument's variable payment if certain criteria are met as defined in GASB 93, paragraph 4. Agreements that effectively maintain an existing hedging arrangement will continue to be accounted for in the same manner as before the replacement of a reference rate.

An exception to the termination of hedge accounting can be applied to both (a) the initial change from an IBOR if all the criteria in GASB 93, paragraphs 4a-4d, are met and (b) the subsequent change when the two changes together represent the government's transition from an IBOR to a Secured Overnight Financing Rate (SOFR). A government may wish to transition from an IBOR to an interim reference rate before it moves to a SOFR when liquidity in the SOFR derivatives market grows. A hedging derivative instrument may be amended or replaced to change the reference rate of the variable payment from an IBOR to a SOFR in two steps as defined in GASB 93, paragraph 6. This two-step process is not necessary to facilitate the replacement of an IBOR with any reference rate other than a SOFR.

GASB 93 also clarifies the hedge accounting termination provisions when a hedged item, such as debt, is amended to replace the reference rate. An amendment of a hedged item to replace the reference rate with another reference rate by either changing the reference rate or adding or changing fallback provisions related to the reference rate, is not a termination event. If the defeasance of IBOR-based debt is necessary for the replacement of an IBOR, then an effective hedging relationship has been terminated for financial reporting purposes.

GASB 53 states "for an expected transaction to be a hedgeable item, the occurrence of the expected transaction should be probable…" GASB 93 clarifies that the uncertainty related to the continued availability of IBORs does not, by itself, affect the assessment of whether the occurrence of a hedged expected transaction is probable. It is not affected by the sustainability or replacement of the IBOR.

Benchmark Interest Rates

GASB 93 removes LIBOR as an appropriate benchmark interest rate of taxable debt for the qualitative evaluation of the effectiveness of an interest rate swap. Note this requirement is effective for fiscal year-end 2022.

GASB 93 identifies a Secured Overnight Financing Rate (SOFR) and the Effective Federal Funds Rate (EFFR) as appropriate benchmark interest rates for the qualitative evaluation of the effectiveness of an interest rate swap for taxable debt. An interest rate on direct Treasury obligations of the U.S. government continues to be an appropriate benchmark interest rate for a derivative instrument that hedges the interest rate risk of taxable debt.

Reference Rate Definition

GASB 93 clarifies the definition of a reference rate and defines it as "a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). A reference rate may be a price or rate of an asset or a liability but is not the asset or liability itself. A reference rate is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument. Other accounting literature may refer to a reference rate as a reference index or an underlying." This definition removes references to common examples of reference rates and it also clarifies that the terms "reference rate" and "underlying" are synonymous.

Leases

GASB 93 provides an exception to the lease modifications guidance in GASB 87 for certain lease contracts that are amended solely to replace an IBOR as the rate upon which variable payments depend. An amendment of the contract solely to replace the IBOR with another rate (that is adjusted to essentially equate the replacement rate and the original rate) by either changing the rate or adding or changing fallback provisions related to the rate is not a lease modification. Note this requirement is effective for fiscal year-end 2022.

To gain an additional understanding of GASB 93, please refer to the following resource:

- The GASB webpage from which you can access a PDF file of GASB 93 as well as other GASB pronouncements – GASB Pronouncement Statement 93

GASB 93 Implementation Considerations

Hedge Accounting:

Agreements that effectively maintain an existing hedging arrangement will continue to be accounted for in the same manner as before the replacement of a reference rate. However, if a government replaces a reference rate with a new rate (including a rate established by triggering a fallback provision) that is neither equivalent to the original rate nor adjusted to essentially equal the original rate, the government implicitly has indicated the intent to end the existing hedging derivative instrument and enter into a new hedging derivative instrument designed to manage identified risks in a different manner. Such an event results in the termination of hedge accounting.

Ordinarily, amending a critical term of a hedging derivative instrument terminates hedge accounting. However, the amendment or replacement of hedging derivative instruments to transition from IBORs will require certain critical term changes. Exceptions to the termination of hedge accounting are appropriate only when the economic substance of the hedging relationship is maintained. The exception should only apply when the terms that affect the changes in fair values and cash flows in the original replacement hedging derivative instruments are identical, except for term changes that may be necessary for the replacement of the reference rate. These term changes are limited and defined in GASB 93 paragraph 5.

When ending the original hedging derivative instrument and entering into a replacement hedging derivative instrument to replace the reference rate, the termination and replacement should occur on the same date to meet the exception in GASB 93.

Governments do not have to evaluate the effectiveness of the hedge when the reference rate is replaced. Governments can continue to evaluate the effectiveness of the hedge at the end of the reporting period.

Up-Front Payments:

A government may make or receive a one-time up-front payment to essentially equate the replacement rate and the original rate. If the up-front payment is limited to what is necessary to essentially equate the rates, it is included as a method to maintain the economic substance of the variable payment of the original hedging derivative instrument. When an up-front payment is made by the government to the counterparty, it is a prepayment of the future net swap payments. A prepayment of the future net swap payments should be classified as an asset because it has present service capacity that the government presently controls. When the up-front payment is received by the government from the counterparty, it is an advance of the future net swap payments. An advance of the future net swap payments should be classified as a liability because it represents a present obligation to sacrifice resources that the government has little or no discretion to avoid. The amount of an up-front payment that is a prepayment or advance of future net swap payments is determined by discounting the amounts by which future payments are affected. Thus, the amortization of the asset or liability should be calculated using the interest method. The up-front payment should be included in the evaluation of effectiveness in the reporting periods in which the net swap payments are affected (as the asset or liability is amortized).

Other considerations:

For entities that hold derivative instruments or leases that will require a reference rate change, discussions with procurement personnel, investment personnel, legal counsel, and/or an outside investment management company, as applicable, may be required to comply with GASB 93 requirements.

Thank you for your time and attention to this important change. Questions regarding this specific update should be directed to Joy Darden at (919) 707-0520 or joy.darden@osc.nc.gov.