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JIBAR to ZARONIA

Key considerations for financial reporting

After the transition away from certain familiar Interbank Offered Rates in foreign jurisdictions, the reforms to South Africa's reference interest rate are now accelerating rapidly. The Johannesburg Interbank Average Rate (JIBAR) will be replaced by the new South African Overnight Index Average (ZARONIA).

The experience gained from the transition of other major rates (such as USD and GBP LIBOR) highlights the wide-reaching implications of this change for an organisation. The JIBAR rate is so embedded in the day-to-day activities of providers and users of financial services, both unregulated and regulated, that even identifying a firm's exposures to it – which is just one element of what is needed to transition from it successfully – is a highly complex task. A timely and carefully co-ordinated transition plan is imperative to ensure a seamless transition that protects business interests and avoids reputational, legal and commercial risks later.

One of the key consequences brought about by the transition from existing benchmark rates to alternative reference rates are the impacts on reported financial results and accounting.

From an International Financial Reporting Standards ("IFRS") accounting point of view, well-documented reliefs were published[1] and have stood up well in assisting with a smooth transition, and for the large part, avoiding accounting disruption and volatility. These reliefs are discussed in this article.

1 https://www.iasplus.com/en/publications/global/ifrs-in-focus/2019/ibor-amendments
https://www.iasplus.com/en/publications/global/ifrs-in-focus/2020/ibor-phase-2

Reference rate reform: A financial reporting perspective

The International Accounting Standards Board ("IASB") identified two groups of accounting issues related to the reference rate reform that could impact financial reporting:

- Pre-replacement issues – these are issues affecting the accounting in the period before the terms of the financial instruments are modified.
- Replacement issues – these are issues that might affect the accounting when an existing interest rate benchmark is either reformed or replaced.

We have provided a summary of the key amendments to the accounting standards arising from the reference rate reform.

Pre-replacement issues

These amendments only affect entities that apply hedge accounting (under IFRS 9[2] or IAS 39[3]) to hedging relationships directly affected by the reference rate reform. A hedging relationship is directly affected only if the reference rate reform gives rise to uncertainties about:

- A contractually or non-contractually specified interest rate benchmark that has been designated as a hedged risk; and/or
- The timing or the amount of cash flows linked to the relevant benchmark rate of the hedged item or the hedging instrument.

These amendments provide temporary relief from applying specific hedge accounting requirements to affected hedging relationships. The reliefs have the effect that reference rate reform should not generally cause hedge accounting to terminate during this pre-replacement phase. However, any hedge ineffectiveness should continue to be recorded in the income statement.

The amendments additionally introduce further disclosure requirements to be considered by the preparers of financial statements.

Replacement issues

The amendments here address issues that might affect accounting application during the reform of an interest rate benchmark.

The amendments are pervasive and will affect many entities. Some of the key amendments are briefly summarised below.

2 International Financial Reporting Standard 9 - Financial Instruments
3 International Accounting Standard 39 - Financial Instruments: Recognition and Measurement

1 Changes in the basis for determining the contractual cash flows as a result of reference rate reform under IFRS 9

The amendments provide specific guidance on how to treat financial assets and financial liabilities where the basis for determining the contractual cash flows change as a result of the reference rate reform. This can include:

- Cases where the contractual terms are amended.
- Cases where the contractual terms are not amended but, for example, where the method for calculating the interest rate benchmark is altered (i.e. where the benchmark interest rate is changed).
- Cases where an existing contractual term is activated such as when a fallback clause is triggered.

As a practical expedient, the change in the basis for determining the contractual cash flows is applied prospectively by revising the effective interest rate. This practical expedient only applies when:

- The change in the basis for determining the contractual cash flows is necessary as a direct consequence of the reference rate reform; and
- The new basis for determining the contractual cash flows is economically equivalent to the previous basis.

When multiple changes are made to a financial asset or a financial liability, the entity first applies the practical expedient (explained above) to those changes required by the reference rate reform. The applicable requirements of IFRS 9 are then applied to any other changes.

For example, consider a loan with a contractual interest rate set at 3 month JIBAR plus a margin of 2%. The margin primarily represents the charge arising from the credit risk of the borrower. If the basis of interest on the loan is changed from the benchmark interest rate (in this example 3 month JIBAR) to a new alternative benchmark interest rate (such as ZARONIA plus the relevant spread required to ensure equivalence to the previous benchmark rate, being 3 month JIBAR), that change is in the scope of the practical expedient.

Any other changes to the contractual terms that are not necessary as a direct consequence of the reference rate reform are not subject to the practical expedient. Using the loan referred in the previous example, assume the contractual margin of the loan were increased (say from 2% to 3%) to reflect the borrower's deteriorated credit risk at the date of transition (compared to the credit risk position at inception). This change would not be in the scope of the practical expedient because it is not required by the reference rate reform. The impact of this change, for accounting purposes, will need to be assessed against the existing IFRS 9 requirements (i.e., for accounting purposes the change may either be considered a modification event or a derecognition event).

2 Hedge accounting under IFRS 9 and IAS 39

The amendments introduced by the IASB allow a series of exemptions from the strict hedge accounting rules so that, in general, hedge accounting should not discontinue solely because of the reference rate reform. For example, hedging relationships (and related documentation) may be amended to reflect changes to the hedged item, hedging instrument and hedged risk without compromising the continued application of hedge accounting. However, entities must ensure that amended hedging relationships continue to meet all qualifying criteria to apply hedge accounting, including effectiveness requirements. Any valuation adjustments resulting from the amendments are required to be recognised as part of hedge ineffectiveness.

3 Other standards

Minor amendments were introduced to other accounting standards. For insurers that apply IAS 39 (instead of IFRS 9), the practical expedient in Box 1 also applies. For lessees applying IFRS 16 (the standard dealing with leases), a practical expedient has been introduced to account for a lease modification required by the reference rate reform (i.e. when re-measuring the lease liability, a revised discount rate that reflects the change in the interest rate benchmark should be used).

It is important to note that the potential accounting impacts arising from the reference rate reform may be extended across various standards (and not just to those standards identified above and to which specific amendments were introduced by the IASB). For example, the reference rate reform:

- Highlights the need to carefully consider the nature and appropriateness of valuation inputs used for fair value measurements in terms of IFRS 13 (e.g., the liquidity of market inputs used in valuations may change as the use of RFRs in market transactions increase over time).
- May change the level allocation of fair value measurements in the fair value hierarchy in accordance with IFRS 13.
- Will have an impact on the determination of discount rates used in valuations required by various accounting standards (e.g., impairment assessments, share-based payment valuations, provisions, environmental rehabilitation liabilities etc.).
- May require the reassessment of the classification and measurement basis of financial assets and financial liabilities in terms of IFRS 9.

The amendments introduce additional disclosure requirements to be considered by the preparers of financial statements.

Looking ahead – accounting consequences

The transition from JIBAR to ZARONIA will present a major challenge, requiring significant time commitment from all stakeholders in executing a carefully structured plan. From an accounting perspective, it is important to gain an understanding of the consequences of transition as this will support in the decisions made in executing the transition plan. Failure to do so may bring about unforeseen accounting consequences reflected in reported financial results.

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