



KPMG LLP
345 Park Avenue
New York, N.Y. 10154-0102

Telephone +1 212 758 9700
Fax +1 212 758 9819
Internet www.us.kpmg.com

2016-310
Comment Letter No. 5

November 4, 2016

Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

RE: Proposed Accounting Standards Update, *Targeted Improvements to Accounting for Hedging Activities* (File Reference No. 2016-310)

Dear Technical Director:

We appreciate the opportunity to comment on the proposed Accounting Standards Update, *Targeted Improvements to Accounting for Hedging Activities*.

We support the Board's efforts to improve the financial reporting for hedging relationships, align the financial reporting with the economic results of an entity's risk management activities, and simplify application of the hedge accounting guidance. However, we believe that certain aspects of the proposal should be modified to achieve the Board's objectives.

We have summarized our views on key aspects of the proposed ASU in this cover letter. Our views and responses to the Board's specific questions are described in more detail in Appendix A and our additional comments are summarized in Appendix B.

Risk component hedging

We generally support the proposal to expand hedge accounting for nonfinancial and financial risk components. However, we believe certain aspects of the proposal should be modified to help practitioners apply the guidance in a consistent manner.

Hedges of nonfinancial items

We support the Board's proposal to permit an entity to designate the variability in cash flows attributable to changes in a contractually specified component stated in a contract to purchase or sell a nonfinancial asset as the hedged risk. We believe the proposal would expand the use of hedge accounting for transactions exposing an entity to nonfinancial risks and would help align the hedge accounting results for those hedges with an entity's risk management strategy.

However, we believe the Board should modify the proposed criteria in paragraph 815-20-25-22A that must be satisfied for an entity to designate the components of a nonfinancial item as the hedged risk. The proposed guidance in subparagraphs 815-20-25-22A(b) and (c) indicates that variability in cash flows related to contractually specified components may be designated as the hedged risk in a cash flow hedge

Technical Director
Financial Accounting Standards Board
November 4, 2016
Page 2

only if the stated components of the price 1) all relate to the cost of purchasing or selling the nonfinancial asset in the normal course of business in a particular market and 2) reflect market conditions at contract inception. The Basis for Conclusions indicates that these criteria are intended to ensure that an entity could not inappropriately apply hedge accounting by inserting in a contract a contractually specified component for which it does not have price exposure and then entering into a derivative to hedge that component. However, we are concerned that the criteria may not be applied in a manner that is consistent with the Board's intent.

We believe that these criteria could be interpreted to require entities to assess whether the stated components of the price in their contracts are consistent with similar provisions in contracts that other market participants have entered into when purchasing or selling the same or similar nonfinancial assets. However, we would expect that there would be circumstances in which an entity would not have access to similar contracts entered into by other market participants. In these circumstances, it is not clear how an entity would, for purposes of facilitating the design and operation of internal controls and the performance of financial statement audit procedures, support that it met these criteria.

Alternatively, if the criteria were interpreted to not require entities to assess whether their contracts are consistent with similar provisions in contracts that other market participants have entered into, we expect that some entities might conclude that *any* contractual provision that is freely negotiated between a purchaser and seller would, by definition, be considered to be executed both in the normal course of business and reflective of current market conditions. This would have the practical effect of obviating the safeguards.

If the Board retains the criteria, we recommend that the Board clarify in the final standard how an entity should apply them.

The Basis for Conclusions indicates that the Board believes that certain of the criteria used to determine whether a contract qualifies for the normal purchases and normal sales scope exception and to determine whether to bifurcate an embedded derivative if a contract is not a derivative in its entirety effectively mitigates its concerns. However, the Board added additional safeguards to the proposal to address contracts that initially did not meet the definition of a derivative and contracts for which an embedded derivative did not require bifurcation. We recommend that the Board consider replacing the guidance in paragraph 815-20-25-22A(b) and (c) with criteria similar to those currently included in paragraph 815-10-15-32 for applying the normal purchases and normal sales scope exception. We believe that these criteria would address the Board's concerns about hedges of components of nonfinancial assets as this change would ensure that the criteria would need to be met for all contracts (not just those that qualify for the scope exception). Replacing the criteria also would alleviate the cost and effort required to apply the new requirements to contracts that already met the normal purchases and normal sales criteria, because they would not need to be evaluated using the additional criteria in 815-20-25-22A(b) and (c). In addition, the Board might also consider including additional guidance indicating that an entity could not hedge a contractually specified component of a contract to purchase or sell a nonfinancial asset if other terms of the contract were written in such a way that exposure to the component was eliminated.

Technical Director
Financial Accounting Standards Board
November 4, 2016
Page 3

Refining the accounting for the hedged item in fair value hedges of interest rate risk

We support the proposed changes to the guidance for measuring the change in fair value of the hedged item in fair value hedges of interest rate risk. We believe the proposed guidance would closely align the accounting for those hedges with an entity's risk management activities.

Other simplifications of hedge accounting guidance

We generally support the Board's efforts to simplify the application of the hedge accounting guidance. However, we believe that certain aspects of the proposal should be modified to allow an entity to implement and properly support its subsequent hedge effectiveness assessment on a qualitative basis.

Assessment of hedge effectiveness

We support the Board's proposal to allow an entity to subsequently assess hedge effectiveness qualitatively if certain conditions are met. However, we recommend that the Board consider modifying this guidance to:

- 1) explicitly permit entities to include in their initial prospective assessment of hedge effectiveness, hypothetical scenarios that simulate changes in factors that affect hedge effectiveness to see whether the hedge relationship still meets the highly effective threshold;
- 2) require an entity to perform a quantitative test of hedge effectiveness if a factor that affects hedge effectiveness changes in a manner that was not contemplated in the initial testing; and
- 3) permit an entity to return to qualitative testing following a quantitative test, as long as it can assert that it can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods.

We are concerned that the proposed guidance implies, through the use of phrases such as "have not changed *to an extent*" (emphasis added), that an entity can perform qualitative assessments even when the factors that were assessed at the beginning of a hedge relationship have changed, as long as the entity qualitatively concludes that the changes would not cause the relationship to be less than highly effective. We believe that assessing the effect that a change in a factor, such as a change in a critical term of the hedged item or hedging instrument, has on hedge effectiveness should be a quantitative exercise, otherwise it may be difficult for an entity to properly support a conclusion that the hedge relationship continues to be highly effective following the change. For this reason, we think that a quantitative assessment should be performed if the factors that were assessed at the beginning of a hedge relationship have changed, unless those changes were contemplated in the initial assessment of hedge effectiveness.

We realize that our recommended approach might, in some circumstances, lead to quantitative assessments being performed when changes in the factors are limited or minor. For that reason, we recommend that the Board consider permitting entities to return to a qualitative assessment if, based on the results of the quantitative assessment, they can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods.

Technical Director
Financial Accounting Standards Board
November 4, 2016
Page 4

* * * * *

If you have questions about our comments or wish to discuss the matters addressed in this comment letter, please contact Kimber Bascom at (212) 909-5664 or kbascom@kpmg.com, or Mark Northan at (212) 954-6927 or mnorthan@kpmg.com.

Sincerely,

KPMG LLP

KPMG LLP

Technical Director
Financial Accounting Standards Board
November 4, 2016
Page 5

Appendix A – Responses to the Board’s Questions

Question 1 – Hedges of nonfinancial items

The Board decided it would allow an entity to designate the hedged risk as the variability in cash flows attributable to changes in a contractually specified component stated in the contract in a cash flow hedge of a forecasted purchase or sale of a nonfinancial asset. Do you agree with that decision? Please explain why or why not. If not, what specific alternatives should the Board consider? Please explain why those alternatives would be beneficial.

We support the Board’s proposal to permit designating as the hedged risk variability in cash flows attributable to changes in a contractually specified component stated in a contract to purchase or sell a nonfinancial asset. We believe the proposal would expand the use of hedge accounting for transactions exposing an entity to nonfinancial risks and would help align hedge accounting with an entity’s risk management strategy. However, we believe that the Board should modify certain aspects of the proposal to help practitioners apply the guidance in a consistent manner. Our views on this question are described in more detail under the heading *Hedges of nonfinancial items* in our cover letter.

Question 2 – Benchmark interest rates

The Board decided that it would retain the concept of benchmark interest rates for hedges of fixed-rate financial instruments and forecasted issuances or purchases of fixed-rate financial instruments, maintain the existing list of permissible benchmark rates, and add the SIFMA Municipal Swap Rate to the list.

- a. *Should the Board retain the current concept of benchmark interest rates for fair value hedges of fixed-rate financial instruments and for cash flow hedges of forecasted issuances or purchases of fixed-rate financial instruments? Please explain why or why not.*
- b. *If the Board continues to maintain the current concept of benchmark interest rates, should the Board consider within the concept expectations that a rate will become widely used?*
- c. *If the Board continues to maintain a list of rates, are there any other rates that should be added to the list? Please explain why a particular rate meets the definition of a benchmark rate.*
- d. *Are there other alternatives to the current concept of benchmark interest rates the Board should consider (for example, a principles-based approach)? Please describe those alternatives.*

We believe the Board should eliminate the concept of benchmark interest rates and instead develop a principles-based approach that requires an interest rate to be widely-used and quoted. This would be similar to the criteria in the proposed ASU for jurisdictions outside the United States.

Technical Director
Financial Accounting Standards Board
November 4, 2016
Page 6

This change would eliminate the need for the Board to maintain an ongoing list of eligible benchmark rates that would necessitate a standard-setting project each time a new rate became widely-used and quoted. The change would also align with the Board's decision to remove the benchmark interest rate concept from cash flow hedging.

We understand that the Board is concerned about separating interest rate risk and credit risk, and ensuring that credit risk elements are not incorporated into interest rate risk hedges. However, there is an element of credit risk – albeit small – that has been incorporated into the current LIBOR benchmark interest rates and the proposed new benchmark rate, the SIFMA municipal swap rate. We believe that excluding elements of credit risk from interest rate risk has become increasingly difficult and may not be necessary as markets evolve and new interest rates become widely used and quoted.

Question 3 – Changes in fair value of hedged item in a fair value hedge: interest rate risk

The Board decided that it would allow an entity to use either the full contractual coupon cash flows or the cash flows associated with the benchmark rate determined at hedge inception in calculating the change in the fair value of the hedged item attributable to interest rate risk, except when the current market yield of the financial instrument is below the benchmark rate at hedge inception. In that instance, the total contractual coupon cash flows would have to be used. Do you agree with this decision? Please explain why or why not.

We agree with the Board's proposal. While using full contractual coupon cash flows continues the requirement under current U.S. GAAP, we believe that allowing entities to use cash flows associated with the benchmark rate determined at hedge inception in calculating the change in the fair value of the hedged item attributable to the hedged interest rate risk (the *basis adjustment*) would better align the accounting result with the economics of an entity's underlying risk management objective of the hedge.

In addition, we agree with the Board's proposal that when the current market yield of the financial instrument is below the benchmark rate at hedge inception, the total coupon cash flows should be used to determine the basis adjustment. When the current market yield of the financial instrument is below the benchmark rate at hedge inception, we believe that it would be inappropriate to permit an entity to hedge the benchmark portion of the cash flows, because that would result in the entity recording basis adjustments based on cash flows that do not exist.

Question 4 – Hedged forecasted transactions that are probable of not occurring

In regard to hedging forecasted transactions, paragraph 815-30-40-5, as amended, states that "a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions." What is

Technical Director
Financial Accounting Standards Board
November 4, 2016
Page 7

your policy on what constitutes a pattern? Are there certain instances or scenarios in which missed forecasts should not be incorporated into the consideration of this pattern?

We believe that determining what constitutes a pattern is a matter of judgment based on individual facts and circumstances. However, we believe that an entity could consider the following factors when determining whether a pattern exists that would call into question the entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions:

- The business or operating circumstances that led the entity to conclude that a hedged forecasted transaction was probable of not occurring;
- Whether the entity experienced other instances in which similar forecasted transactions did not occur; when and what those business or operating circumstances were; and whether the current circumstances are different from the previous instance(s); and
- Whether the circumstances or events that led to the conclusion were within the entity's control.

Question 5 – Comparison to IFRS 9

Are there hedging relationships that would be eligible to meet the requirements in the proposed amendments and IFRS 9, but the hedge results would be recognized and presented differently? If so, please describe the transaction and why it would be recognized and presented differently in accordance with IFRS 9.

As the Board acknowledged in the Basis for Conclusions, although there are some areas of alignment, certain broad principles and objectives of the hedge accounting project in IFRS 9 are different from the proposed ASU. As a result, the recognition and measurement for the same hedge relationship may vary under the proposed ASU compared with IFRS 9. For example, hedge ineffectiveness is not a concept in the proposed ASU, but instead the entire change in the fair value of a hedging instrument designated in a cash flow hedge would be initially recognized in other comprehensive income. However, IFRS 9 retains the concept of hedge ineffectiveness, which is recognized in earnings. In addition, IFRS 9 does not provide guidance on presentation of the changes in fair value of hedging instruments. These differences in recognition and presentation requirements may result in diminished comparability of margins and other financial statement metrics reported under IFRS and U.S. GAAP.

Question 6 – Presentation of changes in the fair value of hedging instruments

Do you agree with the following Board decisions on presentation? Please explain why or why not. If not, what other alternatives should the Board consider?

- a. *For qualifying fair value, cash flow, and net investment hedges, the proposed amendments would modify current GAAP by requiring the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness to be presented in the same income statement line item in which the earnings effect of the hedged item is presented.*

Technical Director
Financial Accounting Standards Board
November 4, 2016
Page 8

- b. *For qualifying fair value, cash flow, and net investment hedges, the proposed amendments would retain current GAAP by requiring changes in the fair value of the hedging instrument excluded from the assessment of effectiveness to be recorded currently in earnings. For qualifying fair value and cash flow hedges, the proposed amendments would modify current GAAP by requiring changes in the fair value of the hedging instrument excluded from the assessment of effectiveness to be presented in the same income statement line item in which the earnings effect of the hedged item is (or will be) presented. For qualifying net investment hedges, there will be no prescribed presentation requirements for changes in the fair value of the hedging instrument excluded from the assessment of effectiveness.*
- c. *For cash flow hedges in which the hedged forecasted transaction is probable of not occurring, the proposed amendments would retain current GAAP by requiring amounts recorded in accumulated other comprehensive income to be reclassified to earnings immediately. However, the proposed amendments would require presentation of reclassified amounts in the same income statement line item in which the earnings effect of the hedged item would have been presented had the hedged forecasted transaction occurred.*

We believe that preparers and users are best able to comment on the usefulness of the proposed guidance on the presentation of the changes in the fair value of hedging instruments.

Question 7 – Changes to the disclosure requirements

Do you agree with the proposed disclosure amendments in (a), (b), and (c) below? Please explain why or why not.

- a. *Cumulative basis adjustments related to fair value hedges*

We believe that preparers and users are best able to comment on the extent and usefulness of the disclosures.

- b. *Quantitative hedge accounting goals, if any, that an entity sets when developing its hedge accounting objectives and strategies and whether it met those goals*

As drafted, the proposed disclosure requirement could be interpreted to apply to hedge accounting goals that the entity has not yet formalized or that have not been approved by those charged with governance. Until goals are formalized and approved, we do not believe they provide decision-useful information for financial statement users. Accordingly, we recommend that the Board modify the proposed disclosure requirement to make it specific to goals that have been formally communicated and approved.

- c. *Revised tabular disclosure for fair value and cash flow hedges that would focus on the effect of hedge accounting on income statement line items.*

Technical Director
Financial Accounting Standards Board
November 4, 2016
Page 9

We believe that preparers and users are best able to comment on the extent and usefulness of the disclosure.

Question 8 – Assessment of hedge effectiveness

Unless the hedging relationship meets one of the exceptions that assumes perfect offset at hedge inception, an entity would be required to perform an initial quantitative test of hedge effectiveness and would be allowed to perform subsequent hedge effectiveness assessments qualitatively unless facts and circumstances change. Do you agree with this proposed change? Please explain why or why not.

We support the Board's proposal to require an entity to quantitatively assess hedge effectiveness at inception of the hedge relationship and to allow an entity to subsequently assess hedge effectiveness qualitatively if certain conditions are met. However, we believe that the Board should modify certain aspects of the proposal to enable an entity to properly support a conclusion that the hedge relationship continues to be highly effective. Our views on this question are described in more detail under the heading *Assessment of hedge effectiveness* in our cover letter.

Question 9 – Assessment of hedge effectiveness

The Board decided that an entity may elect at hedge inception to perform subsequent assessments of effectiveness qualitatively. However, certain changes in the facts and circumstances associated with the hedging relationship in subsequent periods may require a quantitative assessment of effectiveness to be performed. Once an entity determines that a quantitative assessment of effectiveness is required, the entity would be prohibited to return to qualitative testing in periods after this determination is made. Can situations arise in which an entity no longer may assert qualitatively that the hedging relationship continues to be highly effective but when tested quantitatively would be highly effective? If so, please describe those circumstances. Should an entity be allowed to return to qualitative testing after such a significant change in facts and circumstances precluded it in a prior period? If so, please discuss the factors that an entity should consider to justify a reasonable expectation that the hedge will once again be highly effective on a qualitative basis.

We believe that assessing the effect on hedge effectiveness of a change in the factors assessed at the beginning of a hedge relationship should be a quantitative exercise. Otherwise it may be difficult for an entity to support a conclusion that the hedge relationship continues to be highly effective following a change in facts and circumstances. In addition, we recommend that the Board consider permitting entities to return to a qualitative assessment if, based on the results of the quantitative assessment, they can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods. Our views on this question are described in more detail under the heading *Assessment of hedge effectiveness* in our cover letter.

Technical Director
Financial Accounting Standards Board
November 4, 2016
Page 10

Question 10 – Timing of the initial quantitative testing portion of hedge documentation

Do you agree with the proposed amendment that would allow an entity to perform the initial quantitative testing portion of hedge documentation at any time between hedge inception and the quarterly effectiveness testing date using data applicable as of the date of hedge inception? Please explain why or why not.

We support the proposed amendment to allow completion of the initial quantitative testing of hedge effectiveness at any time after the hedge designation but no later than the first quarterly effectiveness testing. We believe this change would provide an entity that is entering into hedging relationships with an acceptable level of flexibility in the timing for completing the quantitative testing that is part of its initial hedge accounting documentation.

Question 11 – Timing of the initial quantitative testing portion of hedge documentation for private companies

The proposed amendments related to the timing of the preparation of hedge documentation and subsequent qualitative testing apply to both public entities and private companies. Are there valid reasons why the content of or the timing of the preparation of hedge documentation should be different for public entities and private companies? If so, please describe the specific types of transactions for which different treatment should be considered.

We are not aware of reasons why the content of and the timing for preparing hedge documentation should be different for private and public companies.

Question 12 and 13 – Effective date and implementation time

Should the effective date be the same for both public business entities and entities other than public business entities? How much time is needed to implement the proposed amendments? Should entities other than public business entities be provided more time? If so, how much more time?

We believe preparers are best able to comment on the effective date and the time that would be necessary to adopt the proposed ASU.

Question 14 – Proposed transition requirements and disclosures

Do you agree with the proposed transition method and disclosures in paragraph 815-20-65-3? Do you agree with the Board's decision not to allow a retrospective transition approach? Please explain why or why not.

We support the Board's proposal to require a modified retrospective transition method. If the Board allowed an entity to elect a retrospective transition method, we do not believe many entities would find the alternative to be cost beneficial. In addition, we agree with the Board's

Technical Director
Financial Accounting Standards Board
November 4, 2016
Page 11

decision not to allow retrospective application of the new measurement methodologies to existing fair value hedges because doing so would require using hindsight.

Technical Director
Financial Accounting Standards Board
November 4, 2016
Page 12

Appendix B – Additional comments

Qualitative assessments of hedge effectiveness

Paragraph 815-20-25-3(b)(2)(iv)(01) lists circumstances in which an entity would perform an initial prospective assessment of hedge effectiveness on a qualitative basis. Two of the specified circumstances, 815-20-25-3(b)(2)(iv)(01)(B) and 815-20-25-3(b)(2)(iv)(01)(F), appear to be effectively the same. 815-20-25-3(b)(2)(iv)(01)(B) is a critical terms match method in which “the critical terms of the hedging instrument and the hedged item match in accordance with paragraphs 815-20-25-84 through 25-85.” 815-20-25-3(b)(2)(iv)(01)(F) is substantively the same because it also requires that “all of the critical terms of the hypothetical derivative and hedging instrument are the same.” We recommend that the Board clarify the distinction between the two paragraphs. For example, we believe that, under current U.S. GAAP, the critical terms match method described in 815-20-25-3(b)(2)(iv)(01)(B) would not apply to hedges of interest rate risk using interest rate swaps or certain cross-currency interest rate swaps. In addition, if the Board intended to use the phrase *critical terms* differently in the two paragraphs, we recommend that the Board clarify the difference and provide additional guidance. Alternatively, if the Board did not intend for there to be differences between the paragraphs, we recommend that one of the paragraphs is deleted.

Portfolios of assets and liabilities in a fair value hedge

Paragraph 815-20-25-12(b)(1) requires that the individual assets or individual liabilities within a portfolio hedged in a fair value hedge share the risk exposure for which they are designated as being hedged. Under current GAAP, when hedging interest rate risk this guidance would often preclude financial assets with different fixed interest coupons or maturities from being included within a portfolio. However, because the proposed standard would permit an entity to 1) calculate the change in the hedged item’s fair value attributable to changes in the benchmark interest rate based on either the full contractual coupon cash flows or the benchmark rate component of the contractual coupon cash flows of the hedged item (815-25-35-13) and 2) measure the change in the fair value of the hedged item attributable to interest rate risk using an assumed term that begins with the first hedged cash flow and ends with the last hedged cash flow (815-25-35-13B), we believe that an entity would be able to define the individual hedged items in a manner that would allow a much broader range of assets to be included within a portfolio (for example, individual loans with significantly different contractual coupons or maturity dates). We believe that this would be a significant change from current application. Therefore, we recommend that the Board provide additional guidance that further clarifies how to apply 815-20-25-12(b)(1) in these circumstances.

Hedges of contractually-specified components of not-yet-existing contracts

Paragraphs 815-20-55-26A and 26B illustrate the application of the guidance in paragraph 815-20-25-22B addressing hedges of contractually specified components of not-yet-existing contracts

Technical Director
Financial Accounting Standards Board
November 4, 2016
Page 13

to purchase or sell nonfinancial assets. These paragraphs include a scenario in which an entity designates the variability in cash flows in a not-yet-existing contract referencing one index (the ABC soybean index) as the hedged risk but then enters into a contract that either references a different index (the XYZ soybean index) or includes a fixed price. The fact pattern in this illustration indicates that the hedge relationship would be discontinued because the designated hedged risk (ABC soybean index) is not present in the executed contract.

However, it is evident from this example that the hedged forecasted transaction is viewed as the purchase of soybeans and, therefore, the hedged forecasted transaction could continue to be viewed as probable of occurring (and therefore associated amounts would not be required to be reclassified immediately from accumulated other comprehensive income to earnings). Thus, we are concerned that the proposed ASU could be interpreted to permit an entity to establish a pattern of identifying contractually-specified components in not-yet-existing contracts and then entering into fixed price contracts without calling into question the entity's ability to accurately predict forecasted transactions. This concern arises because the guidance in paragraph 815-30-40-5 addresses only circumstances in which the hedged forecasted transaction was deemed to be probable of not occurring (as opposed to this circumstance, in which the designated hedged risk is not present in the executed contract). We recommend that the Board consider extending the guidance in paragraph 815-30-40-5 to include circumstances in which an entity asserts that a not-yet-existing contract will include a contractually-specified component but subsequently executes a contract with different terms.