



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

January 3, 2019

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

RE: Proposed Accounting Standards Update, *Codification Improvements – Financial Instruments* (File Reference No. 2018-300)

Dear Technical Director:

We appreciate the opportunity to comment on the proposed ASU, *Codification Improvements – Financial Instruments*.

We support the Board's efforts in responding to stakeholder questions associated with implementing the recognition and measurement, impairment and hedging standards. We generally believe the proposed amendments would address those questions and assist preparers in implementing those standards.

Our recommendations and responses to selected Questions for Respondents are included in the Appendix to this letter.

* * * * *

If you have questions about our comments or wish to discuss the matters addressed herein, 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

Appendix – Responses to Selected Questions for Respondents

Topic 1: Codification Improvements Resulting from the June 11, 2018 Credit Losses TRG Meeting

Issue 1A: Accrued Interest

Question 2:

Do you support the separate accounting policy elections that would allow an entity to choose to (a) write off accrued interest amounts by either reversing interest income or adjusting the allowance for credit losses and (b) elect not to measure an allowance for credit losses on accrued interest if the entity writes off uncollectible accrued interest in a timely manner? If not, please explain why you disagree and what changes should be made instead.

We generally support the Board's proposed guidance and its decision to permit entities to continue existing practices related to reversing or writing off uncollectible accrued interest. However, we believe additional guidance is needed to assist entities in determining whether their policies would result in timely write offs of accrued interest under proposed paragraph 326-20-30-5A as we do not believe the concept would be consistently understood or applied without additional guidance or examples. We suggest the Board either eliminate the timely manner requirement or provide additional interpretive guidance in applying this provision. If it chooses to retain the timely manner requirement, we recommend that the Board specifically address whether a policy that considers write offs timely when the amounts are not more than 180 days past due would be considered appropriate.

Issue 1C: Recoveries

Question 5:

Do the proposed amendments clarify that recoveries are inputs that should be considered when measuring the allowance for credit losses? If not, please explain why you disagree and what changes should be made instead?

We believe the proposed amendments clarify that recoveries are inputs that should be considered when measuring the allowance for credit losses. However, we recommend that the Board require an entity to disclose the amount of recoveries of assets previously written off that are included in the allowance estimate. Because the proposed guidance would result in entities offsetting expected recoveries of previously written off loans against the allowance for expected credit losses associated with existing loans, the usefulness of key ratios, such as the coverage ratio, would be diminished and important information would potentially be obscured from financial statement users. Disclosing the amount of recoveries of assets previously written off that are included in the allowance estimate would enable investors to calculate the expected credit losses associated with existing loans and the loan coverage ratio, which has historically been a meaningful metric for financial statement users.

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In addition, it is not clear how an entity would apply the proposed amendments in paragraph 326-20-30-1 when the allowance for expected credit losses is estimated on a pool (portfolio) basis versus an individual asset level. Specifically, that paragraph indicates that recoverable amounts should be capped so that they do not “exceed the aggregate of amounts previously written off and expected to be written off by the entity.” However, it is not clear whether for purposes of applying the cap an entity would include in the pool amounts fully written off in the past.

We also note that applying the cap may not have the effect intended by the Board, when the allowance for expected credit losses is estimated on a pool basis. This is because a pool of financial assets will generally have expected credit losses that significantly exceed expected recoveries.

For example, assume an entity originates 30-year mortgages and the potential recoveries from foreclosure on some of these mortgages exceed the amortized cost amount. This would be the case if the mortgage were originated in a jurisdiction in which collateral recoveries were not limited to the loan amount or subject to escheatment. Because the recoveries from foreclosure could exceed the original amortized cost, they could also exceed amounts expected to be written off in the future (at the individual asset level). However, when viewed in the context of the entire pool of 30-year mortgages, it is highly unlikely that the cap in paragraph 326-20-30-1 would be met because the expectations for future writeoffs at the pool level would generally be expected to exceed the recoveries related to those assets.

Topic 2: Codification Improvements to Update 2016-13

Question 8:

Do the proposed amendments clarify the guidance in Update 2016-13? If not, please explain which proposed amendment(s) you disagree with and why.

It is not clear whether the Board intended to create a different recognition threshold for the portion of the estimate that relates to recoveries. If the final ASU requires an entity to include in the allowance an estimate of recoveries of amounts previously written off, we recommend that the Board 1) revise the proposed guidance in paragraph 326-20-55-52 to clarify that an entity would need to estimate recoveries based on available information, and would not be able to bypass the estimate when it lacks information, and 2) clarify whether an entity would include an estimate of recoveries even when a recovery was expected only in remote scenarios.

Paragraph 326-20-55-52, as proposed, would state “Bank K determines that the \$500,000 loan made to Entity L is uncollectible, and Bank K has no information that supports an expectation of a future recovery in accordance with paragraph 326-20-30-7.” Paragraph 326-20-30-7 requires an entity to develop an estimate based on available information. In contrast, an entity might interpret this sentence to imply that *no estimate* would need to be made if it *lacks* information about potential recoveries. We suggest that this guidance be aligned with paragraph 326-20-30-7 by

clarifying that the estimate of recoveries in the example was based on consideration of all available information, as opposed to the absence of information.¹

If the final ASU requires an entity to include in the allowance an estimate of recoveries of amounts previously written off, we believe that the ASU should not allow exceptions when recovery amounts cannot be ‘reasonably estimated’ (similar to the concept that is currently applied in ASC 450), because no exception is provided with respect to estimates of credit losses in those circumstances.

In addition, we recommend that the Board clarify whether the guidance in paragraph 326-20-30-10 that “an entity’s estimate of expected credit losses shall include a measure of the expected risk of credit loss even if that risk is remote,” would apply to the estimate of recoveries. Absent additional amendments to paragraph 326-20-30-10, we believe that an entity would generally include an amount of recoveries in the estimate of expected credit losses, even if those recovery scenarios are considered to be remote. In that context, we believe that the Board’s proposed amendments to Example 9 may create confusion because they do not include an estimate of recoveries or indicate that the entity has concluded that no recoveries are expected even in remote scenarios.

Question 9:

Are there other changes that should be made that are directly or indirectly related to the proposed amendments? Please note that the Board will conduct Codification improvement projects on a periodic basis and additional changes may be postponed to a subsequent Codification improvement project.

Discounting under 326-20-30-5

We recommend that the Board consider amending paragraphs 326-20-30-4 and 30-5 to clarify that entities that choose to incorporate discounting into the estimate of expected credit losses should discount (1) all cash flows (rather than selected cash flows), (2) from the date of expected receipt to the reporting date and (3) using a financial instrument’s effective interest rate.

Participants at the November 1, 2018 TRG meeting expressed different views about whether discounting approaches could be used to measure expected credit losses under the guidance in paragraph 326-20-30-5 that addresses methods other than a discounted cash flow method described in paragraph 326-20-30-4. The uncertainty about whether and how discounting approaches could be used to measure expected credit losses under the guidance in paragraph 326-20-30-5 has led to several questions about the application of the guidance in 326-20-30-5.

- Whether an entity is permitted to use an approach that discounts cash flows but assumes that payments will be received when contractually due (rather than when they are expected to be received, effectively ignoring the effect of late payments).

¹ ASC 326-20-30-9 states that economic forecasts need not be made beyond the reasonable and supportable forecast period, however the Board provided an alternative for an entity to revert to historical loss experience. As a result, an estimate is still made.

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- Whether an entity is permitted to use an approach that discounts cash flows but assumes that recoveries will be received at the date of default (rather than when the recovery is expected to be received, effectively ignoring the effect of ‘recovery lag’).
- Whether an entity is permitted to discount expected losses (rather than expected cash flows).
- What discount rate should be applied when discounting amounts under paragraph 326-20-30-5?

We believe that the Board should consider amending the Codification to clarify these points.

Practical Expedient for Financial Assets Secured by Collateral Maintenance Provisions

Paragraph 326-20-35-6 does not address whether the scope of the guidance on collateral maintenance provisions is limited to arrangements that require (1) collateral replenishment with a certain frequency, (2) collateral to be liquid or (3) a narrow range of fair values to determine collateral adjustments or replenishment. Absent additional guidance, it is possible that the guidance in the paragraph will be applied to a broader range of arrangements than originally contemplated by the Board. Therefore, we recommend that the Board address whether these factors should be assessed when determining whether a financial instrument is within the scope of this guidance.

In addition, the following sentence in paragraph 326-20-35-6 should be amended because it is inconsistent with other guidance in the paragraph:

“An entity may determine that the expectation of nonpayment of the amortized cost basis is zero if the borrower continually replenishes the collateral securing the financial asset such that the fair value of the collateral is equal to or exceeds the amortized cost basis of the financial asset and the entity expects the borrower to continue to replenish the collateral as necessary.”

We recommend that the Board amend this sentence to make it consistent with the remainder of the paragraph and clarify that:

- an entity applying the practical expedient should always consider whether it expects the borrower to continue to replenish the collateral as necessary (not just when the expectation of nonpayment of the amortized cost basis is zero); and
- the allowance should be zero whenever the entity applies the practical expedient, and the fair value of the collateral equals or exceeds the amortized cost basis (regardless of whether the provision requires the borrower to continually replenish the collateral so that the fair value of the collateral is equal to or exceeds the amortized cost basis of the financial asset). For example, if a provision required the borrower to maintain collateral

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equal to 98%-102% of the amortized cost of the financial asset, we believe the allowance would be zero as long as the fair value of the collateral is 100% or more of the amortized cost of the financial asset at the reporting date. This would be the case even if the borrower is not required to maintain collateral at amounts equal to or greater than the amortized cost basis.

To address these points, the Board could consider amending the sentence to read:

“An entity may apply the practical expedient only when it determine that the expectation of nonpayment of the amortized cost basis is zero if the borrower continually replenishes the collateral securing the financial asset such that the fair value of the collateral is equal to or exceeds the amortized cost basis of the financial asset and the entity expects the borrower to continue to replenish the collateral as necessary. If the fair value of the collateral at the reporting date equals or exceeds the amortized cost basis of the financial asset, the allowance for credit losses will be zero.”

Topic 3: Codification Improvements to Update 2017-12 and Other Hedging Items

Question 14:

Do the proposed amendments clarify the guidance in Topic 815? If not, please explain which proposed amendment(s) you disagree with and why.

The proposed amendments to paragraphs 815-25-35-9 and 35-9A clarify the amortization period to be used when amortizing the basis adjustment in a partial-term fair value hedging relationship. However, it is not clear which amortization period an entity should use for an outstanding hedging relationship that is not a partial-term hedge because the proposed amendments would delete, “For an outstanding hedging relationship, any amortization of adjustments to the carrying amount of the hedged item shall be performed assuming that the amortization period is the remaining life of the hedging relationship.” We recommend that the Board retain that sentence.

Question 15:

Are there other changes that should be made that are directly or indirectly related to the proposed amendments? Please note that the proposed Codification improvements related to (a) the change in hedged risk guidance for cash flow hedges discussed at the March 28, 2018 Board meeting and (b) use of the word *prepayable* in the shortcut method guidance discussed at the February 14, 2018 Board meeting will be included in a future proposed Update.

Subsequent Assessments of Hedge Effectiveness

Paragraph 815-20-25-3(b)(2)(iv)(01) identifies eight situations in which an initial quantitative assessment of hedge effectiveness is not required, however the guidance is not clear about how an entity should assess hedge effectiveness for each of those situations after its initial assessment. We recommend that the Board consider clarifying the guidance.

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For three situations in paragraph 815-20-25-3(b)(2)(iv)(01), Topic 815 provides subsequent assessment guidance (i.e. when the shortcut method, critical terms match method or simplified hedge accounting approach are used). For the other five situations, Topic 815 does not specify the nature of subsequent assessments to be performed (e.g. whether the assessments should be quantitative or qualitative). The amendment to the transition provisions in this proposal (paragraph 815-20-65-3(e)(5)(iii)) appears to provide guidance for the subsequent effectiveness assessment to be used when the terminal value approach is applied and the critical terms of the hedging relationship initially match in accordance with paragraphs 815-20-25-129 – 25-129A. We recommend that the Board provide guidance for the subsequent assessments of hedge effectiveness for the other situations in paragraph 815-20-25-3(b)(2)(iv)(01).

Hedged Forecasted Transactions That Are No Longer Probable

We believe that the Board should consider clarifying the accounting for a cash flow hedge when the number or amount of forecasted transaction(s) decreases, however the designated derivative hedging instrument continues to be highly effective at offsetting the change in cash flows of the remaining probable forecasted transaction(s). For example, assume an entity uses a forward-starting interest rate swap to hedge the risk of changes in 40 quarterly interest payments associated with an expected issuance of 10-year debt in six months' time. Also assume that, at inception, the terms of the forward-starting swap and the anticipated debt issuance are identical. However, the entity subsequently delays issuance of the debt by three months. As a result, one of the forecasted quarterly interest payments is no longer probable because it will occur outside of the time period specified. Despite the changes in the designated interest payments, the forward-starting interest rate swap (in its entirety) has been and is expected to continue to be highly effective at offsetting the changes in cash flows related to the 39 interest payments that continue to be included in the hedging relationship. Case A of Example 21 in paragraphs 815-30-55-129 – 55-131 illustrates that an entity would terminate the original hedging relationship for the one specific forecasted interest payment that is no longer probable and reclassify into earnings from accumulated OCI (AOCI) the related amount of the net derivative instrument gain or loss.

We believe the following aspects are unclear:

- Can the entire derivative continue to be the hedging instrument, or should a portion of the derivative (relating to one quarterly interest payment) be dedesignated in conjunction with the dedesignation of the forecasted interest payments?
- If the entire derivative continues to be the hedging instrument, should the entity include in other comprehensive income (OCI) the entire amount of subsequent changes in fair value of the derivative? Or should the portion that relates to the forecasted transaction that is no longer probable be recorded in earnings?
- Is the entity required to amend its hedge documentation at the time that some of the forecasted transactions are no longer probable of occurring?

Under ASU 2017-12, lack of perfect effectiveness resulting from an overhedge is recorded in OCI. However, the requirement to reclassify amounts from AOCI into earnings due to the changed forecast in Case A of Example 21 may suggest that when an overhedge is caused by one or more specific forecasted transaction(s) that are no longer probable of occurring, related

amounts should be recognized in earnings (as opposed to OCI). As a result, we encourage the Board to clarify whether or how the ongoing hedging relationship should be changed if a portion of the original designated forecasted transaction(s) is no longer probable of occurring, however the remaining hedging relationship continues to be highly effective.

Question 18:

Do you agree with the specific considerations for transition and the effective date for the proposed amendments to Topic 815? Please explain why or why not.

We believe that specific aspects of paragraph 815-20-65-5(a) are not clear.

- How should an entity that already adopted ASU 2017-12 apply the amendments in its first annual financial statements after the date of issuance of the forthcoming ASU? For example, assume a calendar year-end public entity adopts the forthcoming ASU for quarterly reporting beginning April 1, 2019. The transition provisions in the proposed ASU state that it would be applied “at the beginning of the earlier of an entity’s first quarterly reporting period and first annual reporting period after the date of issuance of Update 201X-XX.” It is not clear what is required for the 2019 annual financial statements because the first annual period began on January 1, 2019, before issuance of the ASU, but that annual period will end after its issuance. We have interpreted the proposed guidance to mean that an entity that prepares quarterly financial statements would adopt the ASU in the first quarterly reporting period following issuance (in the example, the period beginning April 1, 2019) and retain that same adoption date (April 1) for its first annual financial statements after issuance. Alternatively, an entity that does not have quarterly reporting would adopt the ASU at the beginning of the following year (i.e. January 1, 2020). We recommend that the Board clarify these points in the final ASU.
- The transition requirements permit an entity that has already adopted ASU 2017-12 to early adopt this forthcoming ASU. However, because the proposed amendments are effective at the earlier of the first quarterly or annual reporting period after issuance of the amendments, it is not clear under what circumstances an entity would be able to early adopt the ASU.

Topic 4: Codification Improvements to Update 2016-01

Question 21: Are there other changes that should be made that are directly or indirectly related to the proposed amendments? Please note that the Board will conduct Codification improvement projects on a periodic basis and additional changes may be postponed to a subsequent Codification improvement project.

Measurement alternative and observable transactions identified after the reporting date

An entity that applies the measurement alternative in Topic 321 is required to adjust the carrying amount to fair value each time that it observes a transaction price. However, paragraph 321-10-55-8 states that the entity need only “make a reasonable effort (that is without expending undue cost and effort)” to identify observable transactions. It is possible for an entity that used reasonable efforts in a previous period to become aware of an observable transaction that occurred in that previous reporting period. Topic 321 does not contemplate that scenario, nor is it clear how an entity should treat the change under Topic 250.

The Board discussed whether to amend the Codification related to this issue and decided to add a project to its research agenda. We believe these situations will become increasingly common and, therefore, encourage the Board to provide guidance on this issue.

Topic 5: Codification Improvements Resulting from the November 1, 2018 Credit Losses TRG Meeting

Question 25: Do the proposed amendments clarify how an entity should present line-of-credit arrangements that convert to term loans within the vintage disclosure table requirement in paragraph 326-20-50-6? If not, please explain which proposed amendment(s) you disagree with and why.

We believe the date of an entity's most recent credit decision should not affect determining the 'origination year' in which an entity discloses a financial asset under paragraph 326-20-50-6. Specifically:

- We believe that the benefits obtained by determining the origination year in this manner would not outweigh the costs that many entities would incur to incorporate their credit decision process into their financial reporting processes and controls.
- Because the requirement would relate to only line-of-credit arrangements that are converted to term loans, determining the origination year for these loans would be inconsistent with how the origination year would be determined for all other loans.
- The term 'credit decision' may not be consistently understood or applied.

We recommend that an entity disclose all line-of-credit arrangements that are converted to term loans in the new separate column that the Board proposes, unless a modification, extension or renewal resulted in recognizing a new loan under the guidance in paragraphs 310-20-35-9 through 35-12 (consistent with the current guidance in paragraph 326-20-50-7).

In addition, the related illustrative disclosure (Example 15) does not appear to include a disclosure that illustrates the last sentence of the proposed disclosure requirement in paragraph 326-20-50-6A.