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January 13, 2020

Mr. Shayne Kuhaneck
Acting Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

RE: Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815): Codification Improvements to Hedge Accounting (File Reference No. 2019-790)*

Dear Mr. Kuhaneck:

We appreciate the opportunity to comment on the proposed ASU, *Derivatives and Hedging (Topic 815): Codification Improvements to Hedge Accounting*.

We support the Board's efforts to respond to stakeholder questions associated with implementing the targeted improvements to the hedge accounting model introduced by ASU 2017-12, and we believe the proposals address those questions and will assist preparers in implementing the standard. We have identified additional guidance and clarifications related to changing the hedged risk that we believe are needed to ensure the Board's proposals will be consistently applied and to minimize the likelihood that future interpretive guidance may be needed. The following comments and suggestions summarize our more significant recommendations.

Additional guidance and clarifications are needed related to changing the hedged risk

We believe the Board should further develop the 'change in hedged risk' guidance to ensure the proposals will be consistently applied without the need for future interpretive guidance. We believe the most significant issues the Board should address are as follows.

- *Forecasted transactions with multiple undocumented risks:* We believe the Board should clarify how the guidance would be applied when an entity expects to have forecasted transactions with multiple different undocumented risks. Specifically, the Board should clarify whether an entity could choose a new hedged risk or would be required to follow its existing hedge documentation (which, for example, might lead to the 'first' forecasted transactions being considered the hedged forecasted transactions, even if they comprise multiple different undocumented hedged risks). Alternatively, the Board could consider whether an entity should choose the new hedged risk based on its documented method for applying hindsight.
- *Interaction with other hedging relationships:* We believe the Board should clarify how the guidance on shortfalls in transactions with the originally designated hedged risk would be applied when an entity has other existing hedging relationships that are hedging the same

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forecasted transactions but with different hedged risks. Specifically, we believe the Board should require that, upon such a shortfall in hedged forecasted transactions, an entity would not identify (as the hedged item) forecasted transactions with another hedged risk that are being hedged in another hedging relationship.

- *How and when to determine whether a group of hedged forecasted transactions shares risk exposure.* We believe the ‘shared risk exposure’ concept will be applied more frequently under the proposed guidance than it has been previously. Therefore, additional guidance on how to determine whether different risks share risk exposure would be helpful. Specifically, we recommend that the Board require a quantitative assessment for making that determination. We also recommend that the Board clarify whether an entity needs to reassess this requirement when the hedged forecasted transactions in a group involve different risks, but the composition of the group has not changed since the previous reporting period.
- *Partially dedesignated hedging relationships.* We believe the proposed guidance may result in an increase in the frequency of partially dedesignated hedging relationships; however, the accounting for these dedesignations is not clear. For example, it is not clear whether the entire derivative can continue to be the hedging instrument if it is highly effective at offsetting the probable forecasted transactions that remain in the hedging relationship and, if so, whether all subsequent changes in its fair value should be included in OCI.
- *Points in time at which the hindsight guidance should be applied.* While the proposed ASU clarifies that an entity should use hindsight to identify hedged forecasted transactions in some circumstances, it is not clear at what point(s) in time an entity applies hindsight. This is important because the proposed guidance requires an entity to reclassify amounts from AOCI to earnings in the period that includes the date on which hindsight is applied. We believe an entity should be required to apply its hindsight policy at each assessment date and at each reporting date. This would result in the most timely identification of hedged transactions, thereby resulting in the best matching of forecasted transactions affecting earnings with the related amounts being reclassified from AOCI to earnings.

Revised hedging relationships that would not have been highly effective retrospectively

We believe an entity should not be permitted to retain the effects of hedge accounting when a hedged risk changes and the revised hedging relationship would not have qualified for hedge accounting since inception because it would not have been highly effective retrospectively. Rather, in those situations, we believe an entity should be required to apply Topic 815’s existing missed forecast guidance – including reclassifying amounts from AOCI into earnings and evaluating whether it is precluded from applying hedge accounting to similar hedges in the future. We believe that when a revised hedging relationship would not have been highly effective in previous periods, reversing the effects of hedge accounting for that hedging relationship results in higher quality financial reporting.

To this end, we recommend that the Board consider requiring an entity to apply the missed forecast guidance unless one or both of the following conditions are met.

- The revised hedging relationship would have been highly effective in all periods since inception.
- The previous and revised hedged risks share a similar risk exposure.

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Alternatives for hedging contractually specified components of purchases and sales of nonfinancial assets

We believe the Board should change certain aspects of the proposal to hedge the variability in cash flows attributable to changes in a contractually specified component to purchase or sell a nonfinancial asset. Specifically, we recommend the Board consider approaches that would remove criteria that 1) could be met by obtaining or providing nonsubstantive documentation and 2) require an entity to consider other transactions in the nonfinancial asset's spot market, especially when that market is not observable.

To this end, we recommend the Board consider one of the following:

- permit an entity to hedge any index that is clearly and closely related to the nonfinancial asset being purchased or sold (this approach would allow a broader range of hedging relationships to qualify for hedge accounting than would be permitted under the proposed ASU); or
- permit hedge accounting for a contractually specified component in a cash flow hedge of the forecasted purchase or sale of a nonfinancial asset only if the contractually specified component is explicitly referenced in a pre-existing, legally enforceable contract entered into by the purchaser and the seller (this approach would allow a narrower range of hedging relationships to qualify for hedge accounting than would be permitted under the proposed ASU).

The Appendix provides our responses to the questions in the proposed ASU. As part of those responses, we include recommendations for the Board to consider, including further information about those highlighted above and others.

* * * * *

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

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Appendix – Responses to Questions for Respondents

Question 1:

Do the amendments in this proposed Update clarify and improve the guidance in Topic 815? If not, please explain which proposed amendment or amendments do not clarify and improve the guidance and why.

We believe that many of the amendments in this proposed Update clarify and improve the guidance in Topic 815, however we recommend that the Board consider revising certain amendments. Our recommendations are described below and in responses to other questions in this letter.

Relationships with revised hedged risks that would not have qualified for hedge accounting in previous periods

When an entity revises a hedging relationship by changing the hedged risk, the proposed amendments would permit it to retain the effects of hedge accounting even if the revised hedging relationship would never have qualified for hedge accounting based on a retrospective effectiveness test. We do not believe this would improve the guidance in Topic 815. Therefore, we recommend that the Board adopt safeguards (described further below) to limit the potential for an entity to apply hedge accounting for a relationship that would not have qualified for hedge accounting if it was originally documented with the revised hedged risk, and, at the same time, reduce the incentives for an entity to inappropriately estimate the hedged risk, as described below.

Under cash flow hedge accounting, changes in the fair value of a derivative hedging instrument are deferred in accumulated other comprehensive income (AOCI) until the hedged forecasted transaction affects earnings. We believe that when a hedging relationship is revised to change the hedged risk without dedesignation, the historical effects of hedge accounting for that relationship (the amounts deferred in AOCI) should be retained only if the revised hedging relationship would have met the conditions in Topic 815 to apply hedge accounting. Further, we believe that if an entity revises a hedged risk such that the relationship would not have qualified for hedge accounting (e.g. the derivative would not have been highly effective at offsetting the hedged risk since inception of the hedging relationship) the entity should be required to consider such a change to be a missed forecast when evaluating whether it is eligible to apply cash flow hedge accounting for similar hedges in the future.¹ We disagree with the proposed guidance that permits an entity to continue deferring previous derivative gains and losses in AOCI when there is a change in hedged risk, and not to evaluate whether it should be eligible to apply hedge accounting for similar hedges in the future, without first evaluating whether the revised hedging relationship

¹ When a forecasted transaction is not probable, Topic 815 requires the hedging relationship to be discontinued. A 'missed forecast' occurs when it is probable a forecasted transaction will not occur within the originally specified period or an additional two-month window. At that time, amounts remaining in AOCI are immediately reclassified to earnings. A pattern of missed forecasts calls into question the entity's ability to apply hedge accounting in the future. See for example paragraphs 815-30-40-5 through 40-6 and 815-20-25-45-1B.

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would have been highly effective on a retrospective basis had the revised hedged risk been the risk documented at hedge inception.

If an entity is permitted to retain hedge accounting when the hedged risk changes and the revised hedged risk would not have qualified for hedge accounting, we believe entities would have an incentive to inappropriately estimate the hedged risk prior to the hedged forecasted transaction(s) occurring. For example, sometimes, the hedging derivative that would directly offset the hedged risk may not be available, or it may be cost prohibitive to obtain. Instead, an entity may sometimes choose to hedge a risk (Risk A) with a hedging derivative based on a related, but different risk (Risk B). In some of these cases, the Risk B hedging derivative would not be highly effective at offsetting changes in cash flows of the forecasted transaction for Risk A. Under existing requirements, entities currently do not apply hedge accounting for these relationships. However, the Board's proposals would give an entity an incentive to assert that its hedged risk was actually Risk B because hedge accounting would be achieved even if the hedged forecasted transaction's cash flows would be based on Risk A when they occurred.

Paragraph BC21 indicates the Board believes its proposals address the risk of an entity willfully delaying a revision to its best estimate. However, it is not clear how that risk is addressed because the longer an entity delays revising its best estimate, the longer it is permitted to continue deferring derivative gains and losses in AOCI. Further, an entity would not incur a penalty for incorrectly determining its initial best estimate and/or not revising a best estimate until after the forecasted transaction has occurred because the proposed amendments do not require the entity to apply the missed forecast guidance in paragraphs 815-30-40-4 through 40-6 unless the underlying forecasted transactions did not occur.

We believe the Board should address the risk of an entity retaining the historical effects of hedge accounting when a revised relationship would not have qualified for hedge accounting from hedge inception. To this end, we recommend that the Board consider requiring an entity to apply the missed forecast guidance, including reversing amounts in AOCI, when there is a change in the hedged risk unless one or both of the following conditions are met.

- **The revised hedging relationship would have been highly effective in all periods since inception.** This condition would require an entity to perform the retrospective test of effectiveness based on the entity's best estimate of the hedged risk at the assessment date (i.e. the best estimate considering – rather than ignoring – the change in hedged risk).
- **The previous and revised hedged risks share risk exposure.** This would apply the same concept to the previous and revised hedged risk that is used when applying paragraph 815-20-55-23 to groups of forecasted transactions with different hedged risks. For example, an entity would perform robust correlation analysis to demonstrate whether the previous and revised hedged risks share risk exposure. Requiring the relationship to share risk exposure may provide a more practical alternative to requiring an entity to perform retrospective tests of effectiveness since inception of the hedge. Although an evaluation of similarity is different from a test of effectiveness, demonstrated similarity would significantly reduce the likelihood that the revised hedging relationship would not have been highly effective since hedge inception.

Forecasted transactions with multiple undocumented hedged risks

The guidance in the proposed ASU appears to contemplate only scenarios where all forecasted transactions with an undocumented hedged risk will be based on the same index (e.g. when ABC-based transactions don't occur, all of the other forecasted transactions will be based on DEF). However, we believe those forecasted transactions will often be based on multiple different indices, especially when the hedged risk is interest rate risk. We believe the Board should clarify certain aspects of applying the change in hedged risk guidance in these situations. See also our recommendations related to changes in hedged risk when an entity has multiple hedging relationships below.

Identifying the revised hedged risk: We recommend that the Board clarify how an entity should identify the revised hedged risk when it projects a shortfall in forecasted transactions with the originally documented hedged risk. For example, assume Entity A originally designated the hedged risk as the first interest payments based on Rate A. Entity A no longer expects to make interest payments based on Rate A, but does expect to make interest payments based on both Rates B and C. It is not clear whether Entity A:

- may freely elect a different hedged risk at the time it projects the shortfall. In our example, whether Entity A may freely choose payments based on Rate B, Rate C, or a combination thereof at the time it projects a shortfall in Rate A payments; or
- must designate the revised hedged risk based on which transactions are expected to occur first. In our example, whether Entity A must document its new best estimate based on which forecasted interest payments will occur first – payments based on Rate B, Rate C, or a combination thereof.

Alternatively, the Board may wish to consider whether an entity's revised hedged risk should be identified based on its documented method for applying hindsight. This approach would minimize or eliminate differences between the accounting for shortfalls in hedge transactions with the originally documented hedged risk that are identified prior to the forecasted transactions occurring and shortfalls that are identified after the forecasted transactions have occurred. This would alleviate the need for preparers to evidence when these determinations are made.²

Reclassifying amounts from AOCI to earnings: We recommend that the Board clarify how an entity determines the hedged forecasted transaction for purposes of reclassifying amounts from AOCI to earnings when an entity terminates a hedging relationship. Continuing the example above related to identifying the revised hedged risk, assume Entity A terminates the hedging relationship (either voluntarily or because it is no longer highly effective) when it no longer expects to make interest payments based on Rate A, even though Entity A expects to make payments based on both Rate B and Rate C. It is not clear when the amounts in AOCI would be recognized in earnings, for example:

- when the payments based on Rate B are made;
- when the payments based on Rate C are made;

² See also our response to Question 5, which includes our recommendation that the Board clarify that an entity's documented method for applying hindsight must include sufficient specificity to ensure that the entity is not determining the method in connection with applying that hindsight.

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- when the first interest payments are made (regardless of whether they are based on Rate B or Rate C); or
- whether Entity A would have flexibility in choosing when the amounts in AOCI would be recognized in earnings.

Interaction with other hedging relationships

It is not clear how the Board intends the proposed amendments to be applied when an entity has multiple hedging relationships for the same forecasted transaction but with different risks (for example, a company may have one hedging relationship hedging forecasted interest payments on debt with SOFR as the hedged risk and another relationship hedging forecasted interest payments on debt with Prime as the hedged risk). We recommend that the Board require an entity to exclude forecasted transactions that are subject to separate existing hedging relationships when applying the change in hedged risk guidance. This includes both when identifying the revised hedged risk before the hedged transactions have occurred and when applying the missed forecast guidance.

As discussed previously, an entity may have forecasted transactions with multiple undocumented hedged risks. In our previous example, Entity A originally designated the hedged risk as the first interest payments based on Rate A. Entity A no longer expects to make interest payments based on Rate A, but does expect to make interest payments based on both Rates B and C. In this situation, we believe Entity A should not identify payments with Rate B as the hedged items if those payments are already subject to a separate hedging relationship having Rate B as the documented hedged risk.

As another example of how the issue could arise, assume Entity A is hedging its purchases of its first 1,000 metric tons of cocoa beans in March 20X1, and its documented best estimate is that the purchases will be indexed to the ABC index. During March 20X1, ABC purchases only 950 metric tons of cocoa beans (i.e. it has a shortfall of 50 metric tons, all of which had a documented hedged risk of exposure to the ABC index). Also assume that Entity A has forecasted purchases of 1,000 metric tons of cocoa beans in each of April and May 20X1 (i.e. during the additional two-month window), which are hedged in two separate hedging relationships for which the documented hedged risk is exposure to the DEF index. It is probable that Entity A will not have other purchases of either ABC- or DEF-indexed cocoa beans in those months. Since the proposed change in hedged risk guidance is not optional, the guidance may be interpreted as requiring Entity A to identify purchases of 50 metric tons of cocoa beans indexed to the DEF index in April 20X1 as the hedged transactions for the March 20X1 hedge. This situation would result in a ‘domino effect’ because Entity A would then expect a shortfall for the April 20X1 hedge for which it would have to reach into the May 20X1 hedged purchases, resulting in an expected shortfall in the May 20X1 hedge. Instead, our recommended approach (requiring an entity to exclude forecasted transactions subject to separate existing hedging relationships) would result in Entity A reclassifying amounts from AOCI to earnings at the end of March 20X1 (related to the 50 metric tons shortfall), when the shortfall in ABC-indexed purchases has occurred (since it is probable there will not be purchases in April or May that are not already designated in existing hedging relationships).

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A similar issue arises under existing GAAP, but is limited to evaluating whether forecasted transactions with the same hedged risk occurred during the additional two-month window that follows the hedge period. We believe that existing GAAP is not clear with respect to how to apply this guidance. As a result, we understand that there is diversity in practice. However, we believe this issue will arise more frequently under the proposed amendments because it will arise even when the other hedging relationships do *not* have the same hedged risk and is not limited to the additional two-month window that follows the hedge period. As a result, we believe that the extent of diversity in practice could be more significant and we recommend that the Board provide guidance to address this issue.

Changes in the number and timing of payments for hedges of interest rate risk

We recommend that the Board clarify whether an entity is required to document its best estimate of the tenor of a contractually-specified interest rate index that has a tenor (e.g. LIBOR or forward-looking SOFR term rates). Because tenor is identified as an element of hedged risk, we believe an entity should be required to document its best estimate including tenor whenever the index has a tenor. Certain paragraphs³ suggest this is not required.

Construction of perfectly effective hypothetical (PEH) derivative

Some of the proposed paragraphs indicate the PEH should be constructed “on the basis of market data as of hedge inception.”⁴ We believe the Board’s intent as described in paragraph BC52 is that the PEH should have a zero fair value at the inception of the hedging relationship (i.e. BC52 states that that using market data as of hedge inception “would eliminate any off-market components of the forecasted transaction attributable to the passage of time”), rather than a zero fair value when the hedged risk changes. Rather than introducing this new language into the Codification, we recommend that the proposed amendments contain the same language for describing construction of a PEH when the hedged risk has changed as is used in existing paragraph 815-30-35-25(b)(5), including specifying that the PEH derivative must have a “zero fair value at the inception of the hedging relationship.”

Guidance related to shared risk exposure

We believe the Board should clarify three points regarding the requirement in the proposed amendments that forecasted transactions in a group share risk exposure, both at inception and on an ongoing basis.⁵

Change in terminology. In the proposed amendments, the Board retains the existing terminology that the risk exposure needs to be the “same.”⁶ However, the proposed amendments introduce the notion that the hedged risks in the group could be different and still share the same risk exposure.

³ For example, proposed paragraph 815-30-55-1M(a) only requires documenting a specific tenor if the best estimate represents a specific tenor and 815-30-55-55 (Example 9) does not identify a specific tenor although it is an example of a LIBOR-based hedge.

⁴ For example, proposed paragraphs 815-30-55-1D, 55-60 and 55-98C.

⁵ For example, proposed amendments to paragraphs 815-20-55-23 through 55-23B.

⁶ For example, under subparagraph 815-20-25-15(a), a specific forecasted transaction is only eligible for designation as a hedged transaction if it is either (1) a single transaction or (2) included in a group of individual transactions that share the *same* risk exposure for which they are designated as being hedged.

The notion of different risks having the same risk exposure may be confusing to the reader and could make the guidance less understandable. We recommend that the Board recharacterize the requirement as a ‘similar’ risk exposure requirement, such that an entity would assess whether different risks are ‘similar.’

Additional guidance on whether shared risk exposure exists. We believe the ‘shared risk exposure’ concept will be applied more frequently under the proposed guidance than it has been previously. For example, it has been our position under existing GAAP that when an entity hedges the first interest payments on an open portfolio of debt instruments, payments based on 1-month LIBOR cannot be included in a group with payments based on 3-month LIBOR (i.e. the interest payments in the group must have the same tenor and index). Therefore, additional guidance on how to determine whether – for example – 1-month LIBOR and 3-month LIBOR share risk exposure would be helpful. We observe that certain implementation guidance about how to apply the shared risk exposure requirement is included in the basis for conclusions and, as a result, it will not be available to users of the Codification. Specifically, paragraph BC63 indicates that demonstrated high correlation between different indices satisfies the requirement for shared risk exposure. We believe the Board should include this guidance in the Codification, rather than the Basis for Conclusions. We also recommend that the Board require a quantitative assessment for determining whether a group of forecasted transactions with different risks shares a similar risk exposure, and specify the thresholds that should be applied in making this determination.

Additional guidance on when to reassess shared risk exposure. Paragraph BC63 indicates that a group of individual forecasted transactions is required to share risk exposure on an ongoing basis. Paragraph 815-20-55-23 is clear that an entity would be required to reassess whether the items in the group of individual forecasted transactions share the same risk exposure when it identifies that the hedged risk has changed. However, it is not clear whether an entity would need to reassess this criterion in a subsequent reporting period in which there has not been a change in the hedged risk for any of the items in the group. For example, an entity may be hedging a group of forecasted transactions in which some items are exposed to Risk X and some items are exposed to Risk Y. If the entity concludes at hedge inception that Risk X and Risk Y share the same risk exposure, it is not clear whether the entity would need to reassess that conclusion in subsequent periods if it continues to expect that all items in the group will be exposed to either Risk X or Risk Y (i.e. there are no different risks that have been added to the relationship).

Specificity of identifying the hedged forecasted transaction

It appears that the proposed guidance would have significantly different effects depending on how specifically an entity defines the hedged forecasted transaction.

- **Specifically-identified forecasted transaction:** Case C of proposed Example 26⁷ indicates that when an entity documents location as part of the forecasted transaction, it is unable to apply the change in hedged risk guidance in a way that includes purchases at other locations. We believe the same concept would apply to a hedge of interest payments on specifically-identified financial instruments. This approach makes it operationally simple to identify the hedged transaction when it occurs.

⁷ Proposed paragraphs 815-30-55-169 through 55-170.

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- **Broadly-identified forecasted transaction:** Alternatively, an entity could use a first payments or receipts technique to identify the hedged forecasted transaction without regard to any specific location or business unit. Because this approach would result in purchases in all locations or business units being included as forecasted transactions, it reduces the likelihood of a missed forecast. However, the flexibility provided by this alternative approach would increase the burden on preparers, because they might need to search their entire organization to determine whether a forecasted transaction with an undocumented hedged risk occurred.

Because of the significance of this difference, we believe the Board should further emphasize that the change in hedged risk guidance may not be applied when the hedged forecasted transaction has been specifically identified (unless the specifically-identified item changes). The proposed amendments heavily emphasize the Board's view that an entity should be able to update its "best estimate of the hedged risk," which could lead to a mistaken impression that an entity can change a specifically identified hedged forecasted transaction.

We also suggest that the Board consistently clarify in its examples whether a forecasted transaction has been defined broadly (such as the first purchases made within an organization) or narrowly (such a specifically-identified purchase or sale, or a purchase or sale at a specific location). For example, the amendments to paragraphs 815-30-55-1B through 815-30-55-1F describe the hedged forecasted transaction as "forecasted purchases of a specified quantity of soybeans on various dates during June 20X1", however it is not clear whether this is referring to the *first* purchases of a specified quantity of soybeans on various dates during June 20X1 or whether the entity has identified specific purchases planned in June 20X1 as the hedged forecasted transactions. Clarifying the specificity of the forecasted transaction within all examples would help make clear the situations in which an entity is permitted to apply (or prohibited from applying) the change in hedged risk guidance.

Guidance for partially dedesignated hedging relationships

We believe the amendments in the proposed ASU may result in an increase in the frequency of partially dedesignated hedging relationships in practice. For example, the proposed amendments to paragraph 815-20-55-23 indicate that when a change in hedged risk results in the forecasted transactions not sharing risk exposure, hedge accounting should be discontinued or partially discontinued.

Subtopic 815-30's Example 16⁸ addresses the situation in which an entity initially expects to issue fixed-rate debt with a 10-year maturity and quarterly interest payments but revises its forecast to be an issuance of fixed-rate debt with a five-year maturity. In this situation, among other things, an entity would be required to terminate the hedging relationship for each nonprobable forecasted transaction. Separately, Subtopic 815-30's Example 21⁹ illustrates that derivative gains and losses deferred in AOCI related to any payments that are probable of not occurring should be immediately reclassified into earnings.

We believe the Board should clarify the accounting treatment when a hedging relationship is partially discontinued. For example, it is not clear whether the entire derivative can continue to be

⁸ Proposed amendments to paragraphs 815-30-55-94 through 55-98C.

⁹ Paragraphs 815-30-55-129 through 55-131.

the hedging instrument if it is highly effective at offsetting the probable forecasted transactions that remain in the hedging relationship and, if so, whether all subsequent changes in its fair value should be included in OCI. For further information about the specific aspects of the guidance we believe are not clear, please see our response to Question 15 in our comment letter dated January 9, 2019 related to Proposed Accounting Standards Update, *Codification Improvements – Financial Instruments* (File Reference No. 2018-300).

Scope of change in hedged risk guidance – foreign exchange risk

The proposed amendments would not apply when the hedged risk is foreign exchange risk. The Board acknowledges in paragraph BC65 that there is no conceptual basis for excluding hedges of foreign exchange risk from the change in hedge risk guidance. In our experience, foreign exchange risk hedging tends to be an area for which it is relatively more common to experience a missed forecast because the currency of exposure changes. In these circumstances, a missed forecast occurs even if the underlying forecasted purchase or sale continues to be probable and the hedging derivative would be highly effective at offsetting changes in the forecasted transactions with the revised currency. The following are two common types of examples:

- Entity A forecasts that it will sell 100,000 units of a product in Europe during March 2021. Entity A’s best estimate is that the sales will be denominated in Euro based on past experience. However, the sales department concentrated on overseas sales will also accept sales denominated in Pounds Sterling.
- Entity B has a long-term (two-year) project in a foreign jurisdiction to build a factory. Upon completion of the project, Entity B forecasts that it will purchase certain machinery overseas to be used in the factory. Entity B’s best estimate is that the specific machinery purchases will be denominated in Pounds Sterling based on current market pricing of the machinery from Seller A. However, Entity B will seek to pay the least amount for the specific machinery at the time of purchase, so the purchase may ultimately be from Seller B and be denominated in Euro if that market pricing is the least amount at the time of purchase.

We encourage the Board to consider, either as part of this project or in a future hedging project, whether relief should be provided for hedges of foreign exchange risk that is similar to that provided in the proposed ASU for other types of risks.

Question 2:

Are the proposed amendments operable? If not, which proposed amendment or amendments pose operability issues and why?

We believe the Board should change certain aspects of the proposal to hedge the variability in cash flows attributable to changes in a contractually specified component to purchase or sell a nonfinancial asset. We recommend that the Board consider approaches that would remove criteria that 1) could be met by obtaining or providing nonsubstantive documentation¹⁰ and 2) require an

¹⁰ For purposes of this comment, nonsubstantive documentation refers to documentation other than a pre-existing legally enforceable contract, especially in the case of most spot purchase transactions. We note that the majority of spot transaction prices are negotiated based on the total price, as opposed to a component index plus a spread(s), and therefore any breakout of component indices in subsequent documentation may, in those cases, lack substance.

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entity to consider other transactions in the nonfinancial asset's market, especially when that market is not observable.

Specifically, we recommend that the Board consider one of the following:

- permit an entity to hedge any index that is clearly and closely related to the nonfinancial asset being purchased or sold (this assessment would be the same as the clearly and closely related aspect of the normal purchases and normal sales scope exception under paragraphs 815-10-15-30 through 15-34). This approach would broaden the range of hedging relationships involving the purchase or sale of nonfinancial assets that would qualify for hedge accounting (in comparison to the proposed ASU), and would permit the hedging of component risks associated with purchases and sales that occur in spot markets without a pre-existing contract; or
- permit hedge accounting for contractually specified components in cash flow hedges of forecasted purchases or sales of nonfinancial assets only when the contractually specified component is explicitly referenced in a pre-existing, legally enforceable contract entered into by the purchaser and the seller. This approach would narrow the range of hedging relationships involving the purchase or sale of nonfinancial assets that would qualify for hedge accounting (in comparison to the proposed ASU), and would not permit the hedging of component risks associated with purchases and sales that occur in spot markets without a pre-existing contract.

While the two approaches differ significantly in the types of transactions that would be eligible for hedge accounting, either approach would alleviate our concerns about documentation that is, or has the potential to be, nonsubstantive, and the difficulty with observing and assessing other transactions in the spot market. These concerns are discussed further in the paragraphs below.

The proposed guidance in subparagraph 815-20-25-22E(d) requires that, for spot purchases, the pricing formula that includes the explicitly referenced index or price should be based on how the price is determined in that nonfinancial asset's spot market. We are concerned that this criterion may not be operable for two reasons.

- **Difficulty in isolating the effect of a specific component.** Typically, the purchase price in a spot-market transaction involves multiple pricing components that can change from one transaction to another. As a result, it may not be possible for an entity to demonstrate that a transaction price is based on any specific price or index component because it cannot demonstrate the isolated effect of that specific component. This will especially be the case when there are different indices that are potentially relevant to the asset being purchased or sold and that are all highly correlated with one another.
- **Difficulty in identifying spot market transactions other than the entity's own.** The proposed guidance implies that an entity would need to consider spot market transactions other than its own; however, the transaction prices in most spot markets that are not organized exchanges are not observable. Therefore, we would expect that in most circumstances an entity would not have access to information about pricing for transactions entered into by other market participants, making it difficult for an entity to gather evidence about how prices are determined in the nonfinancial asset's spot market. In these

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circumstances, it is not clear how an entity would gather evidence to determine that this criterion is met.

If the Board chooses to continue to limit hedging of indices or pricing components of nonfinancial assets only to situations in which those components are contractually specified, we believe the requirement should be met only when the pricing component is included in a pre-existing substantive contract. This is in contrast to the proposed guidance in paragraphs 815-20-25-22C through 25-22D and the discussion in paragraphs BC73 through BC75, which indicate that the documentation that may evidence a contractually specified component is not limited to legally binding contracts and may be obtained before or after the forecasted transaction occurs.

We believe a contract is generally only substantive when it is legally enforceable and entered into by the buyer and the seller prior to the purchase or sale transaction taking place. We do not believe that accounting requirements should be met by obtaining or producing documentation that is, or has the potential to be, nonsubstantive. Further, we believe that the costs of gathering and maintaining nonsubstantive documentation will in most cases outweigh any potential benefits to financial reporting.

Another reason for limiting hedging of pricing components to only those that were included in contracts that are legally enforceable and entered into by the buyer and the seller prior to the purchase or sale transaction taking place is to improve the operability of the guidance in proposed subparagraph 815-20-25-22E(c). This subparagraph indicates that, for non-spot-market transactions, the variability in cash flows related to contractually specified components may be designated as the hedged risk in a cash flow hedge only if the pricing formula that includes the explicitly referenced index or price *determines the price* of the nonfinancial asset. We expect that, in many cases an entity generally would not be able to demonstrate and support that the pricing formula that includes the contractually specified component determined the price of the nonfinancial asset if the pricing formula was not included in a pre-existing, legally enforceable contract.

Question 3:

Should other changes related to the proposed amendments be made to clarify the intent of the proposed amendments?

We are not aware of any other changes related to the proposed amendments that should be made to clarify the intent of the proposed amendments.

Question 4:

Would any of the proposed amendments require special consideration for private companies that are not financial institutions and not-for-profit entities (except for not-for-profits entities that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market)? If so, which proposed amendment or amendments would require special consideration and why?

We are not aware of any proposed amendments that require special consideration for the identified companies or entities.

Question 5:

Should entities use a method documented at hedge inception to identify hedged transactions using hindsight or should another approach be used? Please explain why. If you support another approach, please explain that alternative.

We agree that an entity should be required to document at hedge inception the method it will use to identify hedged transactions using hindsight. We also believe an entity should be required to use similar methods for similar hedges. In combination, these requirements will limit opportunities to incorporate bias into the selection of hedged transactions and result in greater consistency between reporting periods. However, we believe certain clarifications are needed.

Elements required in the documented method for applying hindsight

We believe the Board should clarify that an entity's documented method for applying hindsight to identify a hedged transaction after it occurred must include sufficient specificity to ensure that the entity is not determining the method in connection with applying that hindsight. Proposed paragraph 815-30-55-1T indicates the method used "should meet the requirements of paragraph 815-20-25-22F and could be based on any of a variety of attributes of the forecasted transaction such as, but not limited to, timing, risk, location or supplier." However, the method described in proposed Example 26 does not include any of the listed attributes and does not appear sufficiently specific to identify the individual hedged transactions, as explained in the next paragraph. Further, proposed paragraph 815-20-25-22F simply requires the method to be reasonable (and that an entity use similar methods for similar hedges).

The method in proposed Example 26 "is to identify transactions that occurred with an undocumented hedged risk that have not yet affected reported earnings as hedged transactions before transactions that occurred with an undocumented hedged risk that have affected reported earnings."¹¹ Such a method lacks sufficient specificity to identify individual hedged transactions.

Our point can be illustrated through an example of the purchase of an asset into inventory, which does not affect earnings until it is later sold out of inventory. Assume an entity is applying hindsight in May 20X1 to identify one purchase from March 20X1 as a hedged transaction and that purchases made on each March 1 and March 31 were not sold from inventory until June and July, 20X1, respectively. The policy described in Example 26 would be insufficient to identify which is the hedged transaction: the March 1 or the March 31 purchase. Although it would be clear that no amount should be reclassified from AOCI into earnings at March 31 20X1, it would not be clear whether the purchase on March 1 or the purchase on March 31 is the hedged transaction. Therefore, it would not be clear whether amounts in AOCI should be reclassified to earnings in June or July 20X1. A method that includes consideration of the timing of transactions (e.g. whether the hedged transactions are the first transactions), such as is suggested in proposed paragraph 815-20-25-22F, would be sufficiently specific.

Point(s) in time for applying hindsight

¹¹ Proposed Example 26 starts at paragraph 815-30-55-161; see method of applying hindsight at subparagraph 815-30-55-162(c)(3).

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We also believe the Board should clarify the point(s) in time an entity is required to apply hindsight. This is important because we believe the proposed guidance requires an entity to reclassify amounts from AOCI to earnings in the period that includes the date on which hindsight is applied (if the identified hedged transactions have already affected earnings on that date). This is especially important when the change in hedged risk guidance is applied for time periods that cross over reporting periods. The following examples demonstrate the need for additional clarification – in both examples, assume Entity A has a March 31, 20X1 reporting date and the documented hedge risk is changes in the ABC cocoa bean index.

- **Example 1 – Hedge period crosses over reporting periods:** Entity A is hedging its first purchases of 1,000 metric tons of cocoa beans in March and April 20X1. During March 20X1, Entity A purchased 400 metric tons of cocoa beans based on the ABC index and 200 tons based on the DEF index. At the end of March 20X1, it is probable Entity A will complete its purchase of 1,000 metric tons of cocoa beans by the end of April 20X1, but its best estimate has changed such that it no longer expects all of those purchases to be based on the ABC cocoa bean index. It is not clear whether Entity A should apply its hindsight policy at the end of March 20X1 (the reporting date and assessment date), the end of April 20X1 (the end of the hedge period), the end of June 20X1 (the end of the additional 2-month window), and/or another date.¹²
- **Example 2 – Additional two-month window crosses over reporting periods:** Entity A is hedging its first purchases of 1,000 metric tons of cocoa beans in February 20X1. Entity A purchased 600 metric tons in February 20X1 and, as of the end of February 20X1, it was not probable Entity A would not purchase 400 more in March through April 20X1 (i.e. the additional two-month window). Entity A ultimately purchased 400 metric tons of cocoa beans based on the DEF index in March and 400 based on the ABC index in April. It is not clear whether Entity A should apply its hindsight policy at the end of March 20X1 (the reporting date) or April 20X1 (the end of the additional two-month window), and/or another date.

At a minimum, we believe an entity should be required to apply its hindsight policy at each assessment date, if applicable, and at each reporting date. This would result in the most timely identification of hedged transactions, thereby resulting in the best matching of forecasted transactions affecting earnings with the related amounts being reclassified from AOCI to earnings. In both of the above examples, if Entity A applies hindsight at the end of March 20X1 and identifies as hedged transactions some purchases in March that were based on the DEF index that also affected earnings in March (i.e. the purchased cocoa beans were sold in March), Entity A would be required (in March) to reclassify amounts from AOCI into earnings associated with those hedged transactions. As a result, its earnings for the reporting period including March 20X1 would include both the earnings effect of the forecasted transaction and the related reclassification of amounts from AOCI to earnings. However, if Entity waits until a later date, the reclassification from AOCI would affect earnings in a later reporting period than the hedged transaction itself.

We believe the Board should also clarify whether the issuance (or availability for issuance, as applicable) of financial statements affects the period in which amounts related to forecasted

¹² These examples assume hedge periods coincide with month-end dates, which is not always seen in practice.

transactions having the undocumented hedged risk should be reported. For example, assume Entity A has a March 31, 20X1 reporting date and has not issued those financial statements at the end of April 20X1. Entity A is hedging its first purchases of 1,000 metric tons of cocoa beans in March and April 20X1 and the documented hedge risk is changes in the ABC cocoa bean index. During March 20X1, Entity A purchased 600 metric tons of cocoa beans based on the ABC index and 150 tons based on the DEF index, all of which affected earnings in March 20X1. At the end of March 20X1, it is probable Entity A will purchase 400 metric tons of cocoa beans based on the ABC index in April 20X1. However, Entity A ultimately purchases only 250 metric tons of cocoa beans in April, all of which were based on the ABC index. As a result, when applying hindsight, Entity A would identify as hedged transactions the 150 tons based on the DEF index purchased in March. We believe the Board should clarify whether Entity A should reclassify amounts from AOCI to earnings related to those 150 tons in its March 20X1 financial statements (which have not yet been issued) or should report that reclassification in the financial statements that include April 20X1 (i.e. the period in which the shortfall in forecasted transactions with the documented hedged risk was identified).

Interaction between change in hedged risk and missed forecast guidance

We recommend that the Board further emphasize in the proposed examples that an entity is required to apply both the proposed change in hedged risk and existing missed forecast guidance. This clarification is needed because an entity may experience a change in its best estimate of the hedged risk concurrently with concluding it is probable a portion of the forecasted transactions will not occur. We believe this could be accomplished by including in the proposed examples a step – which would be performed *before* the two-month window – for assessing the probability that the underlying forecasted transaction will occur. For example, we recommend adding this step to proposed paragraph 815-30-55-1T and proposed Example 26.¹³ Both proposed paragraphs address applying the change in hedged risk guidance when an entity experiences a shortfall in forecasted transactions during the hedge period and does not identify hedged transactions until after the additional two-month window. However, neither proposed paragraph indicates that an entity should assess at the end of the hedge period whether it is probable the forecasted transactions will not occur during this window.

Certain proposed amendments we believe are intended to clarify that applying the change in hedged risk guidance is mandatory (rather than optional) may inadvertently suggest an entity should not apply the missed forecast guidance whenever a change in hedged risk occurs. For example, we recommend clarifications to the following proposed paragraphs:

- **815-30-35-37A and 35-37C:** These paragraphs address reclassifying amounts from AOCI when a hedging relationship is discontinued, including cross-references to other Subtopic 815-30 paragraphs that provide guidance for such reclassifications. We recommend that the cross-references also include references to the guidance for reclassifications related to missed forecasts.
- **815-30-55-10:** This paragraph states that “an entity may not elect to apply the [missed forecast] guidance if the hedged risk changes.” We recommend that this sentence be modified to indicate that an entity is required to apply the missed forecast guidance to transactions that

¹³ Case C, paragraphs 815-30-55-169 and 55-170.

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are probable of not occurring, and to apply the change in hedged risk guidance for all other forecasted transactions.

Question 6:

Is transition guidance needed for entities that may have applied the change in hedge risk guidance to hedges of foreign exchange risk or credit risk or both in reported financial statements?

We are not aware of a need for transition guidance for such situations.

Question 7:

Do you agree with the specific considerations for transition for the proposed amendments? Are other transition provisions needed related to:

- a. The proposed amendments that would require that an entity consider only the designated hedged risk in the prospective assessment of hedge effectiveness for hedges within the scope of the change in hedged risk guidance**
- b. The proposed amendments on the subsequent assessment of hedge effectiveness when a change in hedged risk is identified?**

Please explain why or why not.

In our comment letter dated September 16, 2019 related to Proposed Accounting Standards Update, *Effective Dates* (File Reference No. 2019-750), we recommended that the Board consider developing a new philosophy/framework for transition provisions with the objective of reducing options and complexity. We believe that such a framework would be beneficial because the benefits of simplicity, consistency and comparability would generally outweigh the costs.

We believe the proposed transition guidance related to changes in hedged risk in a cash flow hedge and hedges of contractually specified components in a cash flow hedge of nonfinancial forecasted transactions, which includes four pages of transition guidance, is overly complex. As such, we recommend that the Board consider requiring entities to apply the proposed amendments related to changes in hedged risk and hedges of contractually specified components on a prospective basis. This approach would eliminate both the need for complex, detailed transition guidance necessary for retrospectively applying hedge accounting and the use of hindsight.

However, if the Board decides to retain the transition amendments and allow an entity to elect to apply the guidance retrospectively, we recommend that the Board remove proposed subparagraph 815-20-65-6(d)(5) which allows retrospective designation for new hedging relationships.

Allowing an entity to use hindsight to retrospectively designate new hedging relationships provides an entity with discretion to move gains or losses from previous reporting periods to future reporting periods. We do not believe this is consistent with the objective of high quality financial reporting.

Method for applying hindsight

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Proposed subparagraph 815-20-65-6(b) indicates that if an entity is applying the guidance in proposed paragraph 815-30-35-37C in accordance with proposed paragraph 815-20-25-3(d)(1)(ix) to existing cash flow hedges at the date of the adoption of the amendments of this Update, the “entity is permitted to amend their hedge documentation, without dedesignation, to include the method used to identify a hedged transaction with an undocumented hedged risk after the transaction occurred.” However, proposed paragraph 815-20-65-6(b) does not provide guidance for when such amendments to an entity’s hedge documentation must be finalized. For example, it is not clear whether this documentation would be required to be completed before the date of adoption, before the end of the first quarter after adoption or before an entity’s first required assessment date. We recommend that the Board provide specific guidance to clarify the timing for completion of amendments to hedge documentation.

Question 8:

Do you agree with the proposed effective dates? If the proposed amendments were effective for all public business entities for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years and for all other entities for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2021, would entities have sufficient time to implement these amendments if a final Update is issued in the first half of 2020?

We believe financial statement preparers are best positioned to comment on the sufficiency of the proposed time frames to implement the proposed amendments.