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File Reference No. 2019-790
Financial Accounting Standards Board
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13 January 2020

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 Accounting Standards Update (ASU), *Derivatives and Hedging (Topic 815): Codification Improvements to Hedge Accounting*, issued by the Financial Accounting Standards Board (FASB or Board).

We support the FASB's ongoing effort to improve its hedge accounting model by enabling entities to better portray the economic results of their risk management activities in their financial statements. In addition, we agree with the Board that certain aspects of the guidance in ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, need to be clarified or improved. Constituents faced challenges when implementing the guidance related to (1) changes in the hedged risk of a cash flow hedge (Issue 1 in the FASB's proposal) and (2) hedging contractually specified components in cash flow hedges of nonfinancial forecasted transactions (Issue 2 in the proposal). Therefore, we support the FASB's effort to enhance its guidance in these two areas.

With respect to Issue 1, we agree with giving constituents the flexibility to change the hedged risk in a cash flow hedge after hedge inception because we believe this is consistent with the FASB's broader objective of better aligning financial reporting with an entity's risk management activities. While the proposal would clarify how to apply the change in hedged risk guidance, we believe that additional clarity is needed in certain areas, given the complexity and significance of the changes to aspects of the cash flow hedge accounting model. These items are discussed in our responses to the Questions for Respondents.

With respect to Issue 2, we support the Board's effort to further clarify the requirements for entities to hedge contractually specified components in cash flow hedges of nonfinancial forecasted transactions. For constituents in certain industries, this aspect of ASU 2017-12 represented the most significant improvement to the previous hedge accounting model that had required entities to hedge the overall price risk in these transactions. We believe the amendments would clarify that the requirements to hedge a nonfinancial contractually specified component are not as restrictive as certain constituents believed (e.g., entities are permitted to hedge contractually specified components in spot market transactions, if certain criteria are met). However, we believe the Board should reconsider its proposal related to the requirements to designate a future purchase or sale of a nonfinancial asset through a contract that is accounted for as a derivative as the forecasted transaction in a cash flow hedge. In our



view, the proposed amendment that would require physical settlement of the contract accounted for as a derivative to be probable is overly restrictive and would result in financial reporting that is inconsistent with an entity's risk management activities.

We also support the proposed amendments related to the accounting for dual hedges (Issue 3 in the proposal) and the use of the term "prepayable" under the shortcut method (Issue 4 in the proposal).

Our responses to the questions in the proposal are included in Appendix A. Appendix B contains examples intended to highlight various questions related to the proposed guidance on hedging a forecasted purchase or sale of a nonfinancial asset through a contract that is accounted for as a derivative.

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We would be pleased to discuss our comments with the Board or the staff at its convenience.

Very truly yours,

Ernst & Young LLP

Appendix A – Responses to Questions for Respondents included in the FASB's proposal

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.

Question 2 – Are the proposed amendments operable? If not, which proposed amendment or amendments pose operability issues and why?

Question 3 – Should other changes related to the proposed amendments be made to clarify the intent of the proposed amendments?

While we agree that the proposed amendments generally clarify and improve the guidance in Accounting Standards Codification (ASC) 815, we believe more clarity is needed in certain areas, particularly on Issue 1. In addition, with respect to Issue 2, we do not believe the proposed requirement in ASC 815-20-25-15B(a) related to the probable physical settlement of a derivative contract would improve the guidance in ASC 815. We also note that certain of the proposed amendments related to Issue 1 and Issue 2 may pose operability issues. All of these items are discussed in more detail below.

Issue 1 – Change in hedged risk in a cash flow hedge***Hedging a group of forecasted transactions***

The proposed amendments to ASC 815-20-55-23 indicate that, to hedge a group of forecasted transactions in a single hedging relationship, the transactions in the group must prospectively share the risk exposure for which they are being hedged. We believe more clarity is needed on what is meant by “sharing a risk exposure” in a cash flow hedging relationship and how this should be determined under the proposal, since this concept appears to have a broader meaning than simply sharing the same hedged risk.

For example, paragraph BC64 in the Background Information and Basis for Conclusions of the proposal indicates that the Board did not intend to prohibit the application of hedge accounting when the cash flows associated with forecasted transactions within a group vary with different interest rate indexes or commodity indexes that are highly correlated.

Because US GAAP currently requires that all forecasted transactions hedged in a group must vary with the same index, many entities qualitatively determine that forecasted transactions share a risk exposure under current practice. This differs from fair value portfolio hedges for which ASC 815-20-55-14 provides a quantitative example illustrating when individual assets or individual liabilities within a portfolio would be considered to share the risk exposure for which they are being hedged.

The discussion in paragraph BC63 of the Basis for Conclusions highlighting that an entity may need to perform a robust correlation analysis to determine whether forecasted transactions hedged in a group prospectively share the same risk exposure seems to indicate that the Board believes a quantitative determination could be needed in certain situations. However, it's not clear to us whether the Board intended for cash flow hedges to be held to the same narrow homogeneity threshold applied to fair

value hedges based on the guidance in ASC 815-20-55-14.¹ As noted above, paragraph BC64 refers to different indexes being “highly correlated” – a term that is often considered to be consistent with the notion of “highly effective,” which is defined in practice as a correlation ratio within the range of 80% to 125%. In addition, this view would seem consistent with the Board’s statement in paragraph BC64 that “forecasted transactions varying with different indexes could be aggregated in a group and hedged with a single derivative that provides a highly effective offset to changes in the overall cash flows of the group.”

We recommend that the Board provide additional guidance on this issue in the Codification itself to clarify its intent. If it is the Board’s intention to allow a group of forecasted transactions to be aggregated in a group and hedged with a single derivative as long as that derivative is highly effective at offsetting changes in the overall cash flows of the group, we question the need for a separate homogeneity analysis, since this criterion could be determined solely through the hedge effectiveness assessment.

However, if the Board decides to continue to require a separate homogeneity analysis to be performed, we believe any final ASU should provide guidance for situations where the hedged risk is defined broadly. Paragraph BC25 in the Basis for Conclusions includes an example in which an entity designates its hedged risk broadly as LIBOR because it intends to hedge the first interest payments received in the hedge period related to all tenors of LIBOR. This paragraph also states that “if LIBOR is designated broadly to include all tenors of the index, the entity would need to assess hedge effectiveness in accordance with paragraph 815-20-25-79B and to assess shared risk exposure in accordance with paragraph 815-20-55-23 for all forecasted transactions in the hedged portfolio.”

This seems to imply that an entity must consider its best estimate of the expected tenors of the forecasted transactions when determining whether these transactions share the same risk exposure, regardless of whether the hedged risk has been designated broadly as LIBOR. If this is the Board’s intent, we believe it should be clearly stated in the Codification.

Changes in the method used to assess hedge effectiveness

We note that the proposal would not amend the guidance in ASC 815-20-55-56, which indicates that the mechanism provided in ASC 815 for an entity to change the method used to assess hedge effectiveness is to dedesignate and redesignate the hedging relationship. Therefore, if an entity wanted to change its assessment methodology in conjunction with changing the hedged risk in a cash flow hedging relationship, it would appear that the entity would be required to dedesignate the hedge.

However, we do not believe this was the Board’s intention for hedging relationships that were initially (and subsequently) assumed to be perfectly effective based on the guidance in ASC 815-20-25-3(b)(2)(iv)(A) through (F). For these relationships, if an entity’s best estimate of the hedged risk changes, an assumption of perfect hedge effectiveness would no longer apply because the critical terms of the hedging instrument and the forecasted transaction would no longer match. In practice, some entities include the quantitative assessment method that will be used if the critical terms of the

¹ This guidance indicates that if the change in fair value of a hedged portfolio attributable to the hedged risk was 10% during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9% to 11%.

hedging relationship change in their initial hedge documentation (analogizing to guidance for hedges assessed under the shortcut method or assessed subsequently on a qualitative basis), while others do not. To allow these entities to take advantage of the proposed change in hedged risk guidance for existing hedging relationships, we believe the FASB should provide certain relief related to the guidance on changes to the assessment methodology.

One approach could be for the Board to allow an entity to update its assessment methodology when it changes its best estimate of the hedged risk. If the Board is not comfortable with this approach, it could provide transition relief to give entities a one-time opportunity to change their assessment methodology for existing cash flow hedges. This approach is discussed further in our response to Question 7 because we believe it could be applied to hedging relationships other than those that are initially assumed to be perfectly effective based on the guidance in ASC 815-20-25-3(b)(2)(iv)(01)(A) through (F).

In addition, to address this issue going forward (i.e., for hedging relationships entered into after the adoption of any final guidance), we believe the Board should provide additional guidance specifically indicating that entities are either allowed (consistent with the shortcut method guidance in ASC 815-20-25-117A(a)) or required (consistent with the subsequent qualitative assessment guidance in ASC 815-20-25-3(b)(2)(iv)(3)) to document the quantitative method that would be used to assess hedge effectiveness if the hedged risk changes.

Defining the forecasted transaction (hedged item)

The proposed guidance is clear that an entity should consider the forecasted transaction and the hedged risk to be distinct from each another even if they are documented on an integrated basis. As it pertains to hedges of interest rate risk, this concept is explicitly discussed in proposed paragraph ASC 815-30-35-37D, as well as ASC 815-30-55-1N, which states, "Regardless of the manner in which the forecasted transaction and hedged risk are documented in a cash flow hedge of interest rate risk, the tenor of an interest rate index is considered an attribute of the hedged risk."

The proposed guidance seems to imply that interest-rate tenor or the number and timing of interest receipts or payments should never be used to determine the eligibility of a forecasted transaction for hedge accounting because this is an attribute of the hedged risk. In contrast, the proposed guidance in ASC 815-30-55-170 provides an example where an entity "chooses" to use location as an attribute of the forecasted transaction to determine eligibility for hedge accounting, even though the entity is not required to define eligible forecasted transactions using location. Therefore, it would appear that entities have the flexibility to use certain attributes of a forecasted transaction (e.g., location) but not others (e.g., tenor) as a means to define the population of eligible forecasted transactions.

We are concerned that constituents may be confused about what attributes could or should be used to define the population of eligible forecasted transactions under the proposed guidance. For example, as it pertains to the consolidated financial statements, would the fact that the hedge documentation refers to the legal entity that is expected to execute a forecasted transaction serve to define the hedged item (e.g., forecasted issuance of debt or purchase of inventory executed by this specific subsidiary as opposed to by any other legal entity in the consolidated group) or would management have the flexibility to document whether or not legal entity designation is considered an attribute of the forecasted transaction? We suggest that the Board provide additional guidance on this point in any final ASU to help entities determine whether a forecasted transaction has occurred.

Identifying when a change in hedged risk occurs

The proposed guidance in ASC 815-30-35-37B indicates that an entity must reevaluate its best estimate of the expected hedged risk at least quarterly (i.e., on each assessment date). In addition, paragraph BC54 of the Basis for Conclusions notes that if an entity identifies that a change in hedged risk has occurred at a point in time that differs from when the entity typically assesses hedge effectiveness, the entity would be required to assess hedge effectiveness as of the date the change was identified to determine whether hedge accounting can continue. However, as written, the proposed guidance is not clear about whether an entity is required to attempt to identify the specific date when its best estimate of the hedged risk changed.

While the timing of when the hedged risk has changed may be obvious in certain cases (e.g., when an existing variable-rate debt instrument is refinanced with an instrument that has a different contractually specified interest rate), in other situations it will be less clear. Accordingly, we believe the Board should clarify whether there is an expectation that an entity must attempt to identify the specific date when its best estimate of the hedged risk changed (similar to the guidance in ASC 815-25-40-4 for identifying when a fair value hedging relationship was no longer highly effective)² or, instead, whether an entity may assume that the change in hedged risk was identified on the date that the entity formally reassessed the hedged risk (i.e., at the end of a quarter, assuming this when the entity performs its hedge effectiveness assessment).

We expect that, absent an obvious trigger (such as a refinancing), many entities would only consider whether their best estimate of the hedged risk has changed when the quarterly assessment of hedged effectiveness is performed. In addition, we believe it may be difficult for entities to pinpoint the specific date when their best estimate changed and challenging for auditors to obtain appropriate evidence to support the entity's assertion. Therefore, in clarifying this point in any final ASU, we suggest that the Board consider whether the benefit of such a requirement would justify the cost.

Hedging forecasted interest receipts and payments

We found the proposed guidance in ASC 815-30-55-1J to be confusing as it pertains to hedging interest rate risk associated with the forecasted purchase of fixed-rate debt securities. In these types of hedging relationships, an entity is hedging changes in the benchmark interest rate, but the variability in cash flows may be viewed to differ, depending on whether an entity acquires an existing fixed-rate debt security or a newly issued fixed-rate debt security.

In the case of an existing debt security, the variability in cash flows relates to the amount that will be paid for the security (i.e., the premium or discount resulting from the difference between the benchmark interest rate component of the fixed coupon of the security and the current benchmark interest rate). In the case of a newly issued debt security (i.e., hedging the forecasted purchase of a fixed-rate debt security that will be issued in six months), the variability in cash flows relates to the future interest coupons based on the fixed rate that will be set at the time the security is issued (e.g., the entity pays

² ASC 815-25-40-4 states that if the event or change in circumstances that caused the hedging relationship to fail the effectiveness criterion can be identified, the entity will recognize in earnings the changes in the hedged item's fair value attributable to the risk being hedged that occurred before that event or change in circumstances.

par value for a security since the fixed-rate coupon represents the market coupon rate). This distinction can be viewed as being consistent with the distinction highlighted in Cases A and B of Example 21: *Effect on Accumulated Other Comprehensive Income from Issuing Debt at a Date That Is Not the Same as Originally Forecasted* in ASC 815-30-55-128 through 55-133. This example illustrates the different accounting treatment that would result, depending on how the forecasted transaction is documented, when the expected issuance of the fixed-rate debt is delayed by more than two months.

Based on the proposed guidance in ASC 815-30-55-1J, it is not clear to us whether the FASB believes the distinction noted above matters when an entity documents and identifies the forecasted transaction being hedged in forecasted purchases of debt securities (i.e., whether an entity must distinguish whether it is hedging the forecasted purchase of an existing debt security versus a newly issued debt security). While the guidance in ASC 815-30-55-1J seems to be focused on hedging future interest receipts of a financial asset or future interest payments of a financial liability, we noted that in addressing the documentation requirements related to the expected timing of the forecasted transaction, the proposed guidance in ASC 815-30-55-1J(b) indicates that the documentation should include the entity's best estimate of the timing of future interest receipts or payments or debt purchase or proceeds. It was not clear to us whether the reference in ASC 815-30-55-1J(b) to interest receipts/payments or debt purchase/proceeds was intended to indicate that an entity (1) would be required to specify whether the forecasted transaction(s) being hedged were interest coupons versus the purchase price/proceeds paid or received or (2) could instead document its intention to hedge either interest coupons or the purchase price/proceeds paid or received because at hedge inception the entity does not know whether it will purchase an existing fixed-rate debt security or a newly issued fixed-rate debt security.³

Given the prevalence of this hedge strategy in certain industries, we believe it is important for the Board to clarify whether it believes an entity is required to distinguish between whether it is hedging the forecasted purchase of an existing debt security or a newly issued debt security, when documenting the forecasted transaction.⁴ Unlike the issue addressed by the FASB related to situations where an entity is unsure about whether a debt instrument to be purchased/issued will be fixed rate or variable rate, the issue we are raising here does not pertain to the risk being hedged, but rather to determining the forecasted transaction (i.e., the hedged item).

³ It should be noted that the same derivative could be used as the hedging instrument regardless of whether an entity intended to purchase an existing or newly issued security. In addition, assuming the purchase of the security occurred within the designated hedge period (or in the two months after the hedge period), any amounts deferred in other comprehensive income would be recognized in earnings in a similar manner, regardless of whether the entity acquired an existing fixed-rate debt security or a newly issued fixed-rate debt security. This is because the amortization of any discount or premium is recognized in the same time period as the accrual on the stated coupon.

⁴ While a similar issue can exist when an entity issues fixed-rate debt (refer to Example 21 in ASC 815-30 as noted above), in practice there is less uncertainty regarding whether an entity is hedging the variability in debt proceeds or future interest payments, given the short period of time between when the debt is priced and issued.

Issue 2 – Contractually specified components in cash flow hedges of nonfinancial forecasted transactions

Probable physical settlement of derivative contracts

While we generally agree with the proposed amendments to clarify the guidance on hedging forecasted transactions of nonfinancial items, we believe the FASB should reconsider its proposed guidance regarding the purchase or sale of a nonfinancial asset through a contract that is accounted for as a derivative.

The proposed guidance in ASC 815-20-25-15B(a) would require that physical settlement of the derivative contract be probable in order to apply hedge accounting to the forecasted transaction that could result from this contract. In our view, physical settlement of a specific contract should not be a requirement to qualify for cash flow hedge accounting. Instead, we believe the general requirement that the forecasted transaction be probable of occurring is sufficient. The forecasted transaction in these situations is the physical purchase or sale of a nonfinancial asset. Therefore, hedge accounting would be discontinued if/when it is no longer probable that the physical purchase or sale of the nonfinancial asset (through any means) will occur in the designated hedge period.

The risk that the entity is exposed to and is trying to hedge (i.e., variability in the purchase or sales price of the nonfinancial asset, or a contractually specified component of the purchase or sales price) does not change, regardless of whether the physical purchase or sale stems from a contract accounted for as a derivative. Accordingly, we believe the proposed requirement in ASC 815-20-25-15B(a) would be inconsistent with the FASB's overall objective of enabling entities to better portray the economic results of their risk management activities in their financial statements, since this requirement would result in entities being prohibited from applying cash flow hedge accounting to valid risk management strategies.

We also have concerns about the operability of applying this proposed guidance because many entities may not know at the inception of a hedging relationship how the forecasted transaction they are seeking to hedge will ultimately be executed. For example, assume that on 3 January 2020, an entity can assert that it is probable it will purchase 100,000 bushels of corn in August 2020, but it does not yet know whether the purchase will be made through a spot market transaction, a contract that may or may not meet the definition of a derivative, or a combination of both. In addition, while the entity is confident that it will take physical delivery of the 100,000 bushels of corn in August 2020, it may not know whether it will physically settle any derivative contract that it may enter into at some point in the future.

However, the proposed requirements in ASC 815-20-25-22C through 25-22E seem to assume that entities seeking to hedge a contractually specified component can make these assertions at the inception of the hedge.⁵ In addition, while entities hedging the overall price risk of a forecasted transaction to purchase or sell a nonfinancial asset do not seem to be explicitly required to make these assertions before entering the derivative contract, these entities appear to still run the risk of no longer qualifying

⁵ As noted in proposed paragraph ASC 815-30-55-1C, to hedge a contractually specified component in a not-yet-existing contract, an entity must determine that the requirements of ASC 815-20-25-22C and ASC 815-20-25-22E will be met in the contract once executed in accordance with ASC 815-20-25-22D. The proposed guidance in ASC 815-20-25-22E would require that the forecasted purchase or sale meet the criteria in ASC 815-20-25-15B, which includes the criteria that the occurrence of physical settlement for any contract accounted for as a derivative be probable.

for hedge accounting (and potentially having to reclassify amounts previously deferred in other comprehensive income as discussed below) if they can no longer assert that physical settlement of a derivative contract that had been linked to a hedged forecasted transaction is probable.

Appendix B of our letter provides more detailed examples highlighting additional operational challenges and questions related to the application of the proposed guidance, including whether and when an entity is required to link contracts accounted for as derivatives to hedged forecasted transactions.

In addition, we believe more clarity is needed on the proposed guidance regarding certain aspects of the accounting for situations where an entity that has applied cash flow hedge accounting to a forecasted purchase or sale of a nonfinancial asset through a contract that is accounted for as a derivative can no longer assert that it is probable that the contract will physically settle. While the proposed guidance in ASC 815-20-25-15B is clear that the entity would be required to prospectively discontinue hedge accounting, it also indicates that the guidance in ASC 815-30-40-4 through 40-6 should be applied. This guidance addresses whether the gain or loss related to a discontinued cash flow hedge will continue to be reported in accumulated other comprehensive income, but it is written from the perspective of whether the forecasted transaction will or will not occur, not whether an individual contract will or will not physically settle.

Accordingly, in a situation where it remains probable that the entity will purchase the relevant nonfinancial asset in the spot market (during the hedge period or subsequent two-month period) in quantities equal to or greater than the amount of the hedged forecasted transaction, it is not clear to us whether the Board believes this would be considered a missed forecast and require amounts previously deferred in other comprehensive income to be immediately reclassified into earnings. In our view, such an outcome would appear to be inconsistent with the general principle that seemed to drive many of the clarifications made by the Board with respect to Issue 1 (i.e., that entities acting in good faith should not be penalized with a missed forecast when the forecasted transaction being hedged is still expected to occur). However, if this is the Board's intention, we believe it needs to be clarified in any final guidance.

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 generally do not believe that the proposed amendments would require special consideration for private companies or not-for-profit entities.

However, if the Board chooses to address our previous comment about identifying when a change in hedge risk occurs by clarifying that entities would be required to attempt to identify the specific date that the entity's best estimate changed, we do not see the need for private companies that are not financial institutions and not-for-profit entities (except for not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or over-the-counter market) to reevaluate their best estimate of the expected hedged risk at least quarterly.

As noted in paragraph BC54 of the Basis for Conclusions, certain private companies and not-for-profit entities applying the timing relief in ASC 815-20-25-139 through 25-143 would be permitted to defer their assessment of hedge effectiveness triggered by a change in hedged risk until the date on which the financial statements are available to be issued. That is, while these entities would need to perform an assessment of hedge effectiveness as of the date their best estimate of the hedged risk changed, this analysis would not need to be performed until the date when the financial statements are available to be issued.

In this case, we do not see the relevance of a requirement for these entities to reevaluate their best estimate of the expected hedged risk at least quarterly. Regardless of when or how often this reevaluation is performed, the determination of the period for which hedge accounting could be applied during any fiscal year would be based on an assessment of hedge effectiveness as of the date when the change in hedged risk was identified and would be performed before the financial statements are issued.

In contrast, if the Board chooses to clarify that an entity would not be required to attempt to identify the specific date that its best estimate of the hedged risk changed, we would agree with the Board's proposal requiring all entities to reevaluate their best estimate of the expected hedged risk at least quarterly. This would make it clear that private companies and not-for-profit entities that apply the timing relief in ASC 815-20-25-139 through 25-143 could not default to an assumption that the change in the best estimate of the hedged risk was not identified until the date on which the financial statements are available to be issued.

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.

Given the Board's decision to allow entities to use hindsight to identify hedged transactions with undocumented hedged risk after they occur, we agree that entities should be required to use a method documented at hedge inception to identify these transactions.

However, in our view, this represents one of the most complex aspects of the proposed guidance, and we are concerned that constituents may find it confusing. To help reduce confusion in this area, we suggest the Board clarify that the method required to be documented in accordance with the proposed guidance in ASC 815-20-25-3(d)(1)(ix) is not related to identifying forecasted transactions with undocumented hedge risk based on the timing of when these forecasted transactions occur (i.e., in the hedge period or additional two-month period thereafter).

The proposed guidance in ASC 815-30-35-37C, as well as ASC 815-30-55-1S through 55-1V, would require an entity to first identify all forecasted transactions that are eligible to be identified as hedged that occurred in the originally specified hedge period as the hedged transactions, before identifying any forecasted transactions that occurred in the subsequent two-month period as the hedged transactions. That is, forecasted transactions with undocumented hedged risk that occur in the hedged period must be prioritized over forecasted transactions based on the documented hedged risk that occur in the two months after the hedged period.

It is our understanding that the method required to be documented in accordance with the proposed guidance in ASC 815-20-25-3(d)(1)(ix) is intended to address how an entity will identify and prioritize forecasted transactions with an undocumented hedged risk that are eligible to be identified as hedged transactions that occur in the same time period but are expected to affect earnings in different periods (e.g., forecasted transactions to purchase inventory where the effect on earnings will be recorded in cost of goods sold when the inventory is eventually sold).

A requirement to document the method for identifying and prioritizing these transactions at hedge inception would reduce an entity's ability to "cherry-pick" forecasted transactions with unidentified hedged risk as a way to potentially manage earnings through the timing of when the gain or loss of the hedging derivative deferred in other comprehensive income is reclassified into earnings.

If our understanding is correct, we believe this objective should be further clarified through additional discussion and more robust illustrative examples.

We also believe additional guidance is needed to address situations where an entity identifies transactions in the two-month period after the hedged period to cover a shortfall in forecasted transactions that occurred during the hedged period. Example 24 – Case C in the FASB's proposal touches on this issue, but it doesn't address how an entity should determine which hedging relationship a forecasted transaction should be linked to when there is a shortfall during the hedged period and the entity has multiple hedges in place. That is, the example assumes that even though Entity A expects to purchase soybeans in both June 20X1 and July 20X1, Entity A only wishes to hedge the forecasted purchases expected to occur in June.

We believe that Example 24 – Case C should be modified to address the more realistic situation of Entity A hedging forecasted soybean purchases in both June 20X1 and July 20X1. That is, this example should clarify whether 100 bushels of soybean purchases that occur in July should first be deemed to cover the shortfall in the June hedging relationship (thereby leaving a shortfall in the July hedge that may potentially be covered by August purchases, if any) or instead be linked to the July hedging relationship, thereby resulting in a missed forecast related to the June hedge. While similar questions may occasionally arise in practice today, no guidance currently exists to address them, and we believe the proposed change in hedged risk guidance could result in this becoming a more prevalent issue.

Finally, we note that the proposed guidance in ASC 815-30-35-45A would allow an entity to change its method for identifying hedged transactions with undocumented hedged risk after they occur, as long as the new method is deemed to represent an "improved" method. Given that this method can be based on any of a variety of attributes of the forecasted transaction as noted in proposed paragraph ASC 815-30-55-1T, it is not clear to us how one would determine what constitutes an improved method. Therefore, we suggest that the Board either provide additional information on the factors an entity might consider in making this determination or remove the "improved" threshold from this guidance.

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 any entities that have applied the change in hedged risk guidance in ASU 2017-12 to hedges of foreign exchange risk and/or credit risk. Accordingly, we suggest the Board consider feedback from other constituents to determine whether transition guidance is necessary. If there are entities that have been applying the change in hedged risk guidance to hedges of foreign exchange risk and/or credit risk, we believe the FASB should provide transition guidance for them, given that the scope of this guidance in ASU 2017-12 is unclear.

While there are different approaches the Board could take if it determines that transition guidance is needed, we believe any transition guidance should indicate that an entity that has applied the existing change in hedged risk guidance from ASU 2017-12 in good faith can ignore changes in foreign exchange risk and/or credit risk that occurred since its adoption of ASU 2017-12 when considering its ongoing ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.

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.

We agree with the FASB's proposal to provide entities that have already adopted the amendments in ASU 2017-12 with the flexibility to generally apply all of the proposed amendments either on a prospective basis or on a retrospective basis as of the date of adoption of ASU 2017-12.

In addition, we do not believe additional transition provisions related to items (a) and (b) above are needed. However, as noted above in our responses to Questions 1 through 3 for Issue 1, we recommend that the Board consider providing entities with a one-time opportunity at transition to change their assessment methodology for any existing cash flow hedging relationships.

In our view, such a provision is warranted because at the time entities initially determined and documented their assessment methodology, they may not have considered the potential to continue hedge accounting if the hedged risk changed (i.e., if the hedge remained highly effective based on the revised risk). Therefore, when these existing cash flow hedges were entered into, many entities would not have considered the need or benefit of choosing to document a more robust effectiveness methodology, such as regression analysis, that could increase the chances of the hedge remaining highly effective if the hedged risk changes.

If the FASB decides to allow entities to elect to change their assessment methodology upon transition, this change could be made in conjunction with the amendments to the hedge documentation that would be required for existing cash flow hedges by the proposed guidance in paragraph ASC 815-20-65-6(b).

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, 2020, 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 observe that the proposed amendments related to Issue 1 are more complex than typical Codification improvements and could require entities to develop new or additional processes and controls. However, we believe preparers are in a better position to determine whether the proposed effective dates would give them sufficient time to implement the proposed amendments if a final ASU is issued in the first half of 2020. As a result, we recommend that the Board determine the effective dates based on feedback from these constituents.

Appendix B – Examples of hedging forecasted purchases or sales of a nonfinancial asset through a contract that is accounted for as a derivative

We believe fact patterns described in the examples below are common in certain industries, where physical forward contracts often meet the definition of a derivative but have little or no value because they are either based on an index or an index plus basis. The primary purpose of these contracts is to secure supply or sales, not price. While some of these derivative contracts may qualify for the normal purchases and normal sales (NPNS) scope exception and, therefore, would not be subject to the proposed requirements in ASC 815-20-25-15B if this exception is elected, many do not because the entity is unable to assert probable physical settlement due to operational, logistical or quality-of-product challenges outside of its control.

While we support the Board's proposal to eliminate the requirement that the NPNS scope exception must be applied for a derivative contract with a contractually specified component to qualify for cash flow hedge accounting, we believe the primary benefit of moving away from this requirement is essentially eliminated by the proposed requirement that physical settlement of the derivative contract be probable.

Example 1

On 3 January 2020, Company X expects to purchase 100,000 bushels of corn in Virginia in August 2020. The company currently does not know whether it will enter into physical forward contracts with farmers ahead of time or purchase the entire amount in the spot market. (Note that spot transaction confirmations typically include a contractually specified index that is deemed to be consistent with how spot prices are determined in the market.)

Company X has a history of entering into forward physical contracts with various farmers for some of its forecasted purchases. The forward contracts reference a contractually specified index plus a fixed basis and meet the definition of a derivative (although the fair value of the contracts is limited to changes in value of the basis).

Because the company generally cannot assert physical delivery, these contracts do not qualify for the NPNS scope exception in ASC 815 and are, therefore, required to be accounted for as derivatives. Company X cannot assert that any specific derivative contract will be physically settled because the quality of corn the company has historically purchased from any particular farmer has not always met the required specifications for the company's intended use due to variables outside of the farmer's control. If the quality of the corn does not meet the company's specifications, Company X typically net settles that particular contract and purchases corn of the appropriate quality in the spot market.

Consistent with its policy of hedging only a portion of its purchases, Company X intends to hedge 60% of its forecasted purchases using a futures contract with a notional of 60,000 bushels that it enters into on 3 January 2020.

If the proposed guidance were applied to this fact pattern, it is not clear to us whether the company would qualify for hedge accounting on 3 January 2020, given the uncertainty about how the forecasted transactions will ultimately be executed. For instance:

- ▶ Would Company X qualify for cash flow hedge accounting if at hedge inception it was unable to assert that any individual derivative contract that may be entered into with a farmer would physically settle, but could assert that the combination of spot purchases and purchases under derivative forward contracts that would physically settle are expected to exceed 60,000 bushels? That is, could Company X ignore any derivative forward contracts that are ultimately net settled, as long as it is probable that an amount equal to or greater than the designated notional amount of the forecasted transaction will be physically delivered through contracts that specify the index being hedged?
- ▶ Would the answer to the above question be different if Company X was instead hedging overall price risk (as opposed to a contractually specified component)?

If the answer to either of these questions is “no,” we believe the Board needs to provide additional guidance on how and when entities are expected to link forecasted transactions to either existing or not-yet-existing contracts at hedge inception.

Example 2

Consider a similar fact pattern to Example 1, but in this case, Company X enters into a single forward contract with a farmer to purchase the entire 100,000 bushels of corn in August 2020. Company X cannot assert that the forward contract will physically settle in its entirety, but it has a history of physically settling at least part of its contract.

Given that the company is only hedging 60% of its purchases, it is able to support an assertion that it will physically settle an amount that is at least equal to the quantity of the forecasted transaction being hedged (i.e., 60,000 bushels).

At hedge inception, because the company cannot assert that the entire contract will physically settle, it is unclear whether Company X would be precluded from applying cash flow hedge accounting, even though the company can assert that the forecasted transaction being hedged is probable and the hedge is consistent with the entity’s risk management strategy.