January 13, 2020

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

RE: File Reference No. 2019-790

Dear Mr. Kuhaneck:

PricewaterhouseCoopers LLP appreciates the opportunity to comment on the Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815), Codification Improvements to Hedge Accounting*.

We support the Board's efforts to clarify the objectives and application of certain areas of the hedge accounting guidance amended by Update 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*. However, we have concerns about whether the proposed guidance in Issue 1, Issue 2, and Issue 4 will provide the intended clarifications and desired improvements to hedge accounting under Topic 815.

Issue 1: Change in Hedged Risk in a Cash Flow Hedge

We believe the changes proposed in Issue 1 represent a significant shift in the cash flow hedging guidance in Topic 815. As a result, this issue impacts a large portion of the guidance and a number of concepts within the literature. We believe that additional amendments are needed to address inconsistencies in the guidance with respect to both the language used and the concepts. We have included some examples in the appendix in our detailed responses to the questions.

We understand the Board's objective to distinguish the "hedged risk" from the "forecasted transaction" in a cash flow hedge. We generally support the Board's goal to provide greater flexibility to maintain a cash flow hedging relationship when certain changes to the designated hedged risk occur. However, we note that the proposal adds significant complexity to an accounting model that is already complex. In addition, by separating the hedged risk and the forecasted transaction into different elements of the hedge relationship with different outcomes should they change, understanding how to identify each element is essential in applying the concepts proposed. We believe that the Board should consider providing additional guidance to assist in distinguishing between these concepts.

The amendments in paragraphs 815-30-35-37A through 35-37C provide that, upon a change in the hedged risk, hedge effectiveness is only required to be assessed on a prospective basis. As a result, it would allow a hedging instrument's gains or losses accumulated in other comprehensive income to continue to be deferred until the hedged item impacts earnings for hedge relationships that are not (and may never have been) highly effective. Under the proposed amendments, this can occur when the hedged risk changes but is still considered to be part of the broader forecasted transaction that remains probable of occurring. Accordingly, the proposed guidance would allow the effects of a cash flow hedging relationship to be reported even when a hedging instrument is not a highly effective or commercially viable hedge of the transaction that ultimately occurs. We believe this is inconsistent with the fundamental principles of Topic 815, which continue to require that a hedge has been highly effective in order to achieve income statement offset for hedging activities.

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We believe the proposed guidance should require the hedge relationship to be highly effective in offsetting cash flows of the revised hedged risk on a retrospective basis. If not, we believe an entity should cease cash flow hedge accounting and treat the change in hedged risk as a missed forecasted transaction.

Issue 2: Contractually Specified Components in Cash Flow Hedges of Nonfinancial Forecasted Transactions

We support the Board's efforts to clarify the application of the contractually specified component hedging guidance for nonfinancial items. However, we do not believe the amendments as currently proposed will provide the necessary clarity to address implementation issues that arose after the issuance of Update 2017-12. Specifically, we are concerned that the proposed guidance lacks clarity on evaluating whether certain pricing components are permitted to be hedged as a contractually specified component. We believe a better explanation is needed to evaluate what constitutes a nonfinancial asset's "spot market" in order to assess the appropriateness of a pricing formula. For non-spot market ("forward-based") transactions, we believe further clarification is needed to evaluate whether a contractually specified component "determines" the price of the nonfinancial asset. We recommend providing examples of when the pricing component is both allowed and disallowed from being hedged as a contractually specified component.

In addition, it appears the proposed guidance for spot market transactions is shifting to a *market price convention*, as opposed to a *contractually specified component* model. If that is the Board's intent, we recommend explicitly articulating that within the proposed guidance.

Issue 4: Using the Term Prepayable under the Shortcut Method

We believe the existing terminology used to describe an instrument that is "prepayable" should be retained within the context of the shortcut guidance under Subtopic 815-20. Interpretations of this language are well known and have been consistently applied in practice following a period of interpretation and guidance provided by the Derivatives Implementation Group. We believe that changing this language to "early settlement feature" will cause confusion and potentially result in unintended consequences. If the Board has concerns about confusion with the guidance for "last-of-layer hedges," we suggest amending the language used under the "last-of-layer" guidance as part of the project we understand the Board is already working on that will make significant amendments to this guidance.

The appendix contains our detailed responses to the Questions for Respondents, which expand on the above comments and provides additional observations for the Board's consideration.

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If you have any questions regarding our comments, please contact Chip Currie at (908) 581-4208 or David Schmid at (973) 997-0768.

Sincerely,

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

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Appendix

General Questions

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 have concerns about whether the proposed guidance will provide the intended clarifications and desired improvements to hedge accounting under Topic 815.

Issue 1: Change in Hedged Risk in a Cash Flow Hedge

We do not support all of the proposed amendments in paragraphs 815-30-35-37A through 35-37C. Achieving cash flow hedge accounting under Subtopic 815-30 is premised on designating a hedging instrument that is highly effective in offsetting the variability of cash flows of the designated hedged item. We agree with the proposed guidance in paragraph 815-30-35-37A that requires hedge accounting to be discontinued if the hedging instrument is not expected to be highly effective at achieving offsetting cash flows attributable to the revised hedged risk on a prospective basis. However, we do not agree with the proposed guidance that permits amounts in accumulated other comprehensive income to continue to be deferred when the hedging instrument and revised hedged risk would not have been considered to have had a highly effective hedging relationship on a retrospective basis. When the hedging instrument did not serve as a highly effective or commercially viable hedge of the transaction that ultimately occurs, we do not believe that the presentation of the financial reporting effects of a cash flow hedging relationship will result in decision useful information.

We believe the proposed guidance should require the hedge relationship to be highly effective on a retrospective basis in offsetting cash flows of the revised hedged risk. If it is not, we believe an entity should cease cash flow hedge accounting and treat the change in hedged risk as a missed forecasted transaction.

We also suggest clarifying the proposed guidance in paragraph 815-20-25-3(d)(1)(vi) that requires identification of transactions that are “eligible to be identified as the hedged transaction” when they occur. It is unclear if an entity would be required to identify and document each “eligible” transaction that occurs throughout the hedge period as they occur or if an entity could wait until the end of the hedge period to identify whether the forecasted transaction occurred by looking at historical transactions that occurred throughout the hedge period.

While we support the Board’s efforts to provide greater flexibility in being able to use a substitute hedged risk in a cash flow hedge when changes occur, we believe this is a significant shift in the cash flow hedging model and additional amendments are needed to address inconsistencies in the guidance with respect to both the language and concepts. If the guidance does not require a forecasted transaction to be identified as it occurs, but instead only that it be identified as eligible to be the forecasted transaction when it occurs, this will affect all cash flow hedging relationships, not just those that experience a shortfall in transactions that have the documented hedged risk. For instance, this concept would seem to permit an entity to designate the last 15,000 units purchased or sold as a hedged item, but BC35 notes this designation is precluded.

We also believe the proposed guidance in paragraph 815-20-25-3(d)(1)(ix) regarding the requirement to document the method of identifying hedged transactions with an undocumented hedged risk needs further clarification. We recommend providing additional examples of the different types of methods of identifying hedged transactions with an undocumented hedged risk and what level of detail would be required to be included in the hedge documentation. Without understanding the Board's intent on the type of identification methodology and documentation expected, it is also not clear how to identify what would be considered an *improved* identification method in accordance with paragraph 815-30-35-45A should an entity desire to change the method. It is also unclear if an entity would be precluded from applying the change in hedged risk guidance under paragraphs 815-30-35-37A through 35-37C if they do not document a method of applying hindsight in their documentation.

Issue 2: Contractually Specified Components in Cash Flow Hedges of Nonfinancial Forecasted Transactions

We recommend providing additional clarity on the proposed guidance in paragraph 815-20-25-22E(c) on evaluating whether a pricing formula "determines" the price of the nonfinancial asset in a non-spot market transaction. We believe the price component should substantively impact the price of the nonfinancial asset. Under this approach, a contractually specified component would not have substance in determining the price of the nonfinancial asset if, for example, the pricing formula always yielded a fixed price (e.g., Index A +/- difference between Index A and $7 = $7). In another example, if a pricing formula is based on Index A +/- the difference between Index A and Index B, the price of the nonfinancial asset will always be equal to the price of Index B. In these cases, we do not believe that Index A "determines" the price of the nonfinancial asset. We suggest the following edit to the proposed guidance in paragraph 815-20-25-22E(c):

> For non-spot-market transactions, the pricing formula that includes the contractually specified component determines the price of the nonfinancial asset<u>, and the contractually specified component within the pricing formula impacts the price of the nonfinancial asset</u>.

We also believe it would be helpful to include examples of pricing formulas that determine the price of the nonfinancial asset and those that do not to reduce potential diversity that may arise in interpreting the proposed guidance.

We support the Board's intent to clarify when a contractually specified component can be hedged in a spot market transaction. However, we believe the proposed guidance on spot-market transactions in paragraph 815-20-25-22E(d) would benefit from clarifying how a nonfinancial asset's market should be evaluated. We recommend providing some principles around how to evaluate the spot market in determining whether a pricing formula is consistent with how a nonfinancial asset is priced in its particular spot market. For example, there may be more than one market for a particular nonfinancial asset. When evaluating whether a pricing formula is consistent with a particular spot market, a spot market could be evaluated consistent with how the principal or most advantageous market is evaluated under Topic 820, *Fair value measurement*.

We also note that, with respect to spot market transactions, there are questions around the nature, timing, and extent of documentation that a company should obtain to demonstrate that a spot market transaction had a contractually specified component. Illustrative examples of what would be acceptable and what would be insufficient (for example, on the timing of documentation) may help address these questions.

For hedged items that are accounted for as derivatives, we do not believe gross physical settlement should be required *at the contract level* in order to qualify as the hedged item (paragraph 815-20-25-15B). Instead, we believe an entity should be permitted to hedge an amount relating to a portfolio of contracts accounted for as derivatives with variability in the contractually specified component designed as the hedged risk that is considered probable of being physically settled (e.g., hedging the first 100 units to occur). This would be consistent with the treatment of other hedged forecasted transactions in a cash flow hedge which do not require a probability assessment at an individual contract level.

Issue 4: Using the Term Prepayable under the Shortcut Method

We believe the existing terminology used to describe an instrument that is "prepayable" should be retained within the context of the shortcut guidance under Subtopic 815-20. Interpretations of this language are well known and have been consistently applied in practice following a period of interpretation and guidance provided by the Derivatives Implementation Group. We believe that changing this language to "early settlement feature" will cause confusion and potentially result in unintended consequences. If the Board has concerns about confusion with the guidance for "last-of-layer hedges," we suggest amending the language used under the "last-of-layer" guidance as part of the project we understand the Board is already working on that will make significant amendments to this guidance.

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

We believe providing additional explanation will enhance operability and understandability of the proposed guidance in a number of areas.

We understand the Board's objective to distinguish the "hedged risk" from the "forecasted transaction" in a cash flow hedge. We generally support the Board's goal to provide greater flexibility in maintaining a cash flow hedging relationship when certain changes to the designated hedged risk occur. However, we note that the proposal adds significant complexity to an accounting model that is already complex.

One area where the proposed amendments may add complexity is the proposed guidance in paragraphs 815-30-35-37B and 35-37C, which has the potential to cause additional sequencing (or layering) issues when attempting to identify the hedged transactions. Cash flow hedging programs are often established to hedge a series of forecasted transactions (e.g., purchases of a particular commodity) that are expected to occur over a consecutive number of months (e.g., hedging purchases in August, September, October, November), with each month representing a separate and distinct hedging relationship. The proposed guidance would require entities to track transactions, both with the designated hedged risk and eligible transactions with an undocumented hedged risk, that may cross over multiple periods that are designated in separate and distinct hedging relationships. This overlap may lead to questions related to which hedge relationship a transaction should be attributed.

We recommend the Board indicate that a shortfall in transactions in one period (e.g., September) can be fulfilled with transactions that occur in a subsequent period (e.g., October) only after all of the hedged transactions for that specific period (e.g., October) have been fulfilled. That is, transactions are only eligible to fulfill a shortfall once all other forecasted transactions already designated in a separate hedging relationship have occurred. We recommend that the example in paragraphs 815-30-55-1T through 55-1V be expanded to demonstrate how the guidance would be applied in these situations. It might also be helpful to clarify that a transaction with an *undocumented* hedged risk can only be used to satisfy a shortfall, in accordance with paragraph 815-30-35-37C, if it is not already the designated hedged item in a separate hedging relationship.

We also believe the proposed guidance in paragraph 815-20-25-3(d)(1)(vi) may be challenging to operationalize. An entity with global operations may have "eligible" transactions that occur within a consolidated subsidiary. It may be operationally challenging if an entity is required to include its worldwide operations in its analysis. As a result, an entity may specify locations within its hedge documentation based on where delivery is anticipated.

By separating the hedged risk and the forecasted transaction into different elements of the hedge relationship with different outcomes should they change, understanding how to identify each element is essential in applying the concepts proposed. The proposed guidance in paragraphs 815-30-55-169 through 55-170 seems to indicate that location would be considered part of the forecasted transaction; consequently, location would not appear to fall within the proposed guidance in paragraphs 815-30-35-37A through 35-37C for addressing changes in the hedged risk. However, we understand that the Board may have intended to permit flexibility in cash flow hedges if the delivery location changed (for example more natural gas is delivered to Plant A as opposed to Plant B due to changes in production location). If location can never be considered part of the hedged risk, we believe the Board should clarify why the proposed guidance on changes in location is viewed differently than the proposed guidance on changes in the designated hedged risk. Specifically, we believe the Board should clarify its intent behind the proposed guidance in paragraph 815-30-55-170, as it seems inconsistent with how the Board is treating a change in the designated hedged risk (including the ability to change from 12 individual one month hedges of interest rates to two 6-month hedges).

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

Yes, we believe the Board should consider the following additional clarifications:

- The proposal deletes the guidance in paragraph 815-20-25-19B, but it is unclear why this guidance is no longer considered relevant. It appears this guidance would still be necessary to address situations when there is uncertainty over whether the future forecasted debt instrument will be fixed or variable. We believe the application of the change in hedged risk guidance to hedging relationships in which the hedged risk changes between a contractually specified rate and a benchmark interest rate should be clarified.

- BC18 indicates that an entity would be allowed to change the hedged risk from one benchmark interest rate to another benchmark interest rate if hedging the forecasted issuance or purchase of a fixed-rate debt instrument. We recommend including this as guidance in the authoritative literature. This additional clarification could be included within the proposed amendment in paragraph 815-30-55-1P.

- By separating the hedged risk and the forecasted transaction into different elements of the hedge relationship with different outcomes should they change, ensuring clarity of what would be considered an element of the forecasted transaction, and what would be considered part of the hedged risk becomes critical. In our response to Question 2, we highlighted location as an example of this. It is also unclear how the proposed change in hedged risk guidance in paragraphs 815-30-35-37A through 35-37C would apply when hedging the forecasted acquisition of a marketable debt security under paragraph 815-20-25-16(b). It is unclear whether the identification of a security would be considered the hedged risk or the forecasted transaction. This would impact a company's ability to change the forecast from the purchase of one security to a different security.

- Paragraph 815-20-55-23 (and other related paragraphs) provide that transactions hedged in a group must prospectively share the risk exposure for which they are hedged. We believe the intent of this guidance is to ensure that individual items hedged in a group have *similar* risk exposures as opposed to sharing the *same* risk exposure. Thus, we believe the intent of this proposed guidance should be clarified by including the concept of "similar."

- Assuming a hedge relationship can continue following a change to the hedged risk, paragraph 815-30-55-1E indicates that an entity shall perform a retrospective assessment of effectiveness for the revised hedged risk only for periods in which it was the revised hedged risk. Many companies use regression analysis to perform their hedge effectiveness analysis, which include multiple historic data points. Questions may arise regarding how the retrospective effectiveness assessment should be performed. It is unclear whether all data points used in the assessment should be based on the revised hedged risk. If not, the guidance should clarify if there should be any data points included from the periods before the best estimate of the hedged risk changed that include the prior best estimate of the hedged risk. We suggest including an example in the implementation guidance to clarify.

- There is some inconsistency in the terminology used to describe the hedged risk. Some paragraphs (e.g., 815-30-55-1L) use "best estimate of hedged risk" and others (e.g., 815-20-55-79P) use "hedged risk." We recommend being consistent in how the guidance refers to the hedged risk or clarify if the use of different language was intentional and the impact of the different language.

- We recommend the following edit to paragraph 815-30-55-1R to clarify that an entity should assess hedge effectiveness using the documented hedged risk as there may be other factors that impact hedge effectiveness that may not be considered "related only to" the documented hedged risk.

> An entity's assessment of hedge effectiveness in a cash flow hedge is associated with its documentation of the hedging relationship required by paragraph 815-20-25-3(b)(2) and further discussed in paragraphs 815-30-55-1M and 815-30-55-1Q. At inception of a cash flow hedge of a forecasted transaction and on an ongoing basis, an entity should assess hedge effectiveness ~~related only to~~ <u>using</u> the hedged risk documented as its best estimate of the hedged risk at the inception of the hedging relationship or subsequently documented in accordance with paragraph 815-30-55-1Q…

- We believe it is unclear if the Board intended to refer to "all risks" as opposed to only "risks that are eligible to be hedged" in the examples illustrated in paragraphs 815-30-55-152(d) and 815-30-55-155(b).

- Example 9 (beginning in paragraph 815-30-55-54) illustrates a scenario when an entity issues a series of short-term 90-day notes, which appear to be zero coupon notes (e.g., commercial paper). The example identifies this as a hedge of a contractually specified interest rate. However, we understand that a hedge of a future issuance of a zero coupon note would be considered a hedge of a benchmark interest rate. We do not believe it would be appropriate to consider a hedge of a series of forecasted issuances of fixed rate instruments as a hedge of a contractually specified rate. Updating this example also provides an opportunity to provide guidance on the ability to change a hedged risk from a benchmark interest rate to a contractually specified rate.

- Paragraph BC92, which elaborates on paragraph 815-20-25-15(e), precludes hedging the periodic cash flows attributable to a variable rate bond that is being accounted for under the fair value option. This does not seem consistent with the ability to hedge the contractually specified component in a derivative contract pursuant to paragraph 815-20-25-15B. We believe the hedging of periodic cash flows attributable to a variable rate bond should be permitted or the basis for conclusions should further elaborate on the rationale for such an exclusion.

- Within BC74, the Board states that acceptable documentation for evidencing a contractually specified component is broader than a legal contract binding on one or both parties. We believe this should be included in the guidance in Topic 815 as it seems to be an important concept that is not reflected in the proposed guidance.

- The proposed guidance on documenting the forecasted transaction appears to set a different specificity threshold between hedges of financial instruments and hedges of nonfinancial assets. Specifically, paragraph 815-30-55-1K notes that an entity should not document the forecasted transaction so broadly that many different transactions could be identified as the hedged forecasted transaction. However, the proposed guidance related to, for example, hedges of interest rate risk appears to allow for a broader interpretation of interest payments that constitute the hedged risk. We believe the Board should consider whether it intended different thresholds.

- We believe the proposed guidance in paragraph 815-20-55-38 should clarify that the notional of the hedging instrument in the net investment hedge will be based on a *hypothetical* carrying amount. Accordingly, the amount reported in cumulative translation adjustment may be based on a notional that exceeds the carrying value of the debt on the balance sheet. This concept appears to be addressed in the example in paragraph 815-20-55-129, but we believe it would be helpful to explicitly state this concept in paragraph 815-20-55-38.

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 special considerations.

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.

As previously noted, we do not believe the Board's proposed guidance is sufficiently clear as to what should be documented at hedge inception as it relates to using hindsight. We believe that an entity should document at hedge inception a methodology to identify hedged forecasted transactions using hindsight if the use of hindsight will be permitted. We also believe that this methodology should be consistently applied and, consistent with paragraph 815-30-35-45A, any changes to the methodology would require discontinuance of the existing hedge relationship.

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?

It does not appear that Update 2017-12 explicitly excluded foreign currency risk and credit risk from the change in hedged risk guidance. Therefore, we believe the Board should include transition guidance for entities that may have applied the change in hedged risk guidance to hedges of foreign currency risk or credit risk.

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 generally agree with the proposed transition requirements.

We believe it would be helpful if the Board included in the guidance the types of hedge relationships that may require rebalancing by increasing or decreasing the designated notional of the hedging instrument provided by the proposed guidance in paragraph 815-20-65-6(e).

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 believe the changes proposed in Issue 1 represent a significant shift in the cash flow hedging guidance in Topic 815, which may require more time to implement. However, we note that this question is best addressed by financial statement preparers.