Chatham
FINANCIAL

January 13, 2020

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

By email: director@fasb.org

Re: File Reference No. 2019-790, Exposure Draft, *Codification Improvements to Hedge Accounting*

Dear Mr. Kuhaneck,

Chatham Financial Corp. ("Chatham") is pleased to comment on the Financial Accounting Standards Board's ("FASB" or "Board") Proposed Accounting Standards Update, *Codification Improvements to Hedge Accounting* (the "Exposure Draft" or "Proposal"). Chatham serves as a hedging advisor to more than 3,000 clients annually across the globe and in many industries. Chatham assists more than 600 clients with the application of the hedge accounting provisions of Accounting Standards Codification ("ASC") 815, International Accounting Standards ("IAS") 39, or International Financial Reporting Standards ("IFRS") 9. In addition, Chatham's involvement with clients often leads to discussing the application of the hedge accounting guidance with their auditors. As a result, we believe we are well positioned to provide helpful feedback related to the Board's efforts to improve the hedge accounting guidance in Topic 815.

We appreciate the Board's efforts to clarify and improve certain aspects of ASC 815 and we support many of the concepts in the Proposal. However, we have concerns primarily regarding the operability and auditability of some of the proposed changes within Issue 1 and Issue 2. As a result, the majority of our feedback is related to these items. We support the items proposed in Issues 3 and 4.

We thank the Board for its consideration of our comments and would be pleased to discuss these issues in more detail with the Board or staff. Please do not hesitate to contact me at (484) 731-0228 or at dgentzel@chathamfinancial.com.

Sincerely,

Dan Gentzel
Managing Director, Hedge Accounting
Chatham Financial Corp.

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

Specifying the hedged transaction: Clarify further that it is permissible to scope transactions into or out of a hedging relationship

We support a hedge accounting framework that permits an entity to update its risk management approach as it develops over time. The Exposure Draft is a positive step toward allowing that flexibility. However, the Proposal seems to emphasize that a change to an undocumented risk is the entity's desired risk management approach in the case of a shortfall in a documented risk. The guidance supporting that other possibilities may exist is buried in an example (example 26, Case C). We believe it would be useful to clarify in the body of the codification the extent to which hedged transactions can be scoped into or out of a hedging relationship.

For example, many interest rate hedging strategies today combine the hedged risk and the forecasted transaction when specifying the hedged transaction. Paragraph 815-30-55-1H would require an entity to separate the hedged risk from the hedged transaction, and 815-30-55-1N specifies that interest rate tenor is an attribute of the hedged risk and not the forecasted transaction.

Consider an entity that defines its forecasted transactions as *only* 1-month LIBOR interest payments across multiple loans. This strategy appears to not be permitted in the Exposure Draft, as 815-30-35-37A and 35-37C suggest that an entity is required to look for a revised or undocumented hedged risk if the initial best estimate of the hedged risk changes. Further, the proposed requirement to search for undocumented risks could also require entities to release amounts deferred into other comprehensive income to match with the earnings recognition of exposures the hedging relationship was not intended to cover.

Further, consider an example of an entity that believes its risk profile has changed from 100% of index A to 75% of index A and 25% of index B, even though it has other transactions linked to index A. The guidance in ASC 815-30-35-37B requires a shortfall in the designated hedged risk to occur before an entity is permitted to apply the guidance in 815-30-35-37A. We interpret this guidance to indicate that an entity cannot change its best estimate of the hedged risk unless it expects to have a shortfall in the originally specified transactions. If the entity expects all of the index A-linked transactions to occur, either from the original source or any other source, this guidance would not permit the entity to rebalance the hedging relationship to include 25% of index B without dedesignating the hedging relationship. That outcome seems contrary to the principle of changing the hedged risk during the hedging relationship. We recommend that the Board clarify the guidance if this is not the intended interpretation.

Further, we recommend that the Board clarify whether entities are permitted to define the combination of hedged risk and hedged transaction in such a way as to explicitly include or exclude certain transactions. We also request that the final guidance include application examples, including examples related to interest rate hedges of both specifically identified hedged transactions and more broadly across a pool of transactions. Case C of example 26 (815-30-55-169 and 170) presents a scenario where hedged transactions were defined very narrowly and specifically. The hedged transactions were not purchased at the originally specified location and therefore were deemed to not occur. Amounts related to the missed forecasted transaction were immediately reclassified from Accumulated Other Comprehensive Income to Earnings. The final sentence of 815-30-55-170 indicates "In this case, Entity A chose to use location as an attribute of the forecasted transaction to determine eligibility for hedge accounting; however, in accordance with paragraph 815-20-2-3, an entity is not required to define eligible forecasted transactions using location." From our perspective, this supports that it is permissible to define the hedged transaction in such a way to scope out items from being considered hedged transactions, but the guidance feels buried in an example. We recommend the FASB make this concept more prominent in the body of the codification and not limit it to an example.

These challenges are further exacerbated when the entity is a lender with a pool of you-pick-‘em loan assets. Economically, the interest rate risk in such a pool can be appropriately controlled with a simple interest rate swap. The economic objective is generally to hedge variable rate interest, but not to control the optionality inherent within these instruments. In these cases, the entity does not own the option to change the interest rate, which is held by the borrowers, and the entity cannot reject any of the alternatives in order to make the assessments more efficient. This is a very common hedging relationship for lenders.

In the past entities have used the combination of the interest rate and interest period to define a pool of loan assets that will generate the hedged transactions. It is not clear to us whether this type of scoping remains viable given the required search for undocumented risks. If this approach is no longer viable, it appears that to effectively scope out transactions, an entity may be required to create a closed pool of transactions in order to meet the specificity requirements.

We recommend that the Board further refine the model in the Proposal and/or provide additional examples to illustrate its view of how these hedging relationships should operate.

<u>Shared risk analysis: Clarify further the expectations and thresholds of a shared risk analysis</u>

We have observed in practice that the vast majority of entities define the hedged transaction and hedged risk sufficiently narrow for cash flow hedges such that they have not been required to perform an analysis to demonstrate that all transactions share the risk exposure for which they are being hedged (“shared risk analysis”). We have also observed in practice that the thresholds are different for shared risk analysis (i.e., 90%-110%) and quantitative effectiveness assessments (i.e., 80%-125%). We are concerned that, while the Exposure Draft may permit additional flexibility to hedge multiple risks with a single derivative, it would effectively increase the hurdle to apply hedge accounting if entities are required to perform both a shared risk analysis and an assessment of effectiveness each period.

We believe a separate shared risk analysis is unnecessary when an entity performs a statistical regression analysis as part of its quantitative effectiveness assessment using the best estimate of the risk and transaction(s) being hedged. If an entity desires to hedge a range of risks with a single derivative and it can (1) demonstrate that the hedging relationship is highly effective and (2) reliably allocate the derivative gain/loss to the line item(s) hedged, we believe hedge accounting should be permitted. Further, it seems unnecessary for entities to effectively meet a higher threshold for a shared risk analysis when the Proposal also permits amounts to be reclassified from other comprehensive income to earnings to offset transactions from undocumented hedged risks that would not pass an appropriate effectiveness assessment. In addition, eliminating the shared risk analysis or equating the thresholds of shared risk and quantitative effectiveness assessment would remove unnecessary administrative burdens in managing a hedging program.

As a result, we recommend that the Board either remove the requirement to perform a separate shared risk analysis from Topic 815 or update the authoritative guidance to state that the threshold to pass a shared risk analysis is highly effective (i.e., the same as the threshold for effectiveness assessment). In addition, we believe it would be useful for the Board to indicate whether it believes that an entity can rely on the effectiveness assessment to satisfy the shared risk requirement. If the shared risk analysis has a purpose that is distinct from a quantitative effectiveness assessment, we ask the Board to clearly state the principles for each analysis, including indicators of passing and failing results for a shared risk analysis and examples of how the test should be performed.

We also recommend that the views in BC63 and BC64 relating to the shared risk analysis be incorporated into the authoritative guidance. We believe Example 24 (815-30-55-149 through 55-157) could be expanded to include an additional Case where the entity intends from inception to hedge transactions with multiple exposures (e.g., XXX amount related to ABC soybean index and XXX related to XYZ soybean index) and to provide detail on how the entity performed its shared risk analysis and the considerations it used to conclude that the two indexes share the same risk.

<u>Timing of effectiveness assessment and documentation of revised risk: Provide further clarity and relief with respect to the timing of effectiveness assessments and update to hedge documentation when a revision of a hedged risk occurs</u>

Paragraph 815-30-35-1B emphasizes that an entity would begin assessing effectiveness based on the revised hedged risk as of the date that the change was identified. In addition, BC54 indicates that if an entity typically assesses hedge effectiveness at quarter end it would need to perform this analysis as of the date the hedged risk changes. Further, 815-30-55-1Q discusses that an entity should update its hedge documentation at the same time it assesses effectiveness under 815-30-35-1B. We are unclear whether the Board intends entities to perform the hedge effectiveness assessment and update hedge documentation based on the revised hedge risk (1) contemporaneously on the date the entity's best estimate of the hedged risk changed or (2) on the date the entity typically performs its hedge effectiveness assessments. We believe that View (1) would be burdensome to apply in practice and may lead to many situations where entities do not perform the assessment and update hedge documentation in a timely manner. We recommend that the Board permit entities to perform these activities at the end of a quarter as part of its normal hedge accounting activities.

<u>Practical issues with you-pick-'em debt: Provide additional clarity and examples specific to "you pick-'em debt"</u>

In regards to applying the shared risk analysis guidance in 815-20-55-22 and 815-20-55-23, as well as the changes in the hedged risk guidance in 815-30-35-37A (both as originally issued in ASU 2017-12), perhaps the most debated type of hedging relationship we have encountered in practice is a hedge of "you-pick-'em" debt. This ubiquitous form of debt features a wide variety of interest rate options both in terms of index (i.e., LIBOR, Prime, Fed Funds Effective Rate) and interest calculation period (i.e., weekly, 1 month, 3 months, 6 months, 9 months). While the Proposal provides substantial additional guidance, we are concerned that it has not sufficiently addressed this very common scenario.

We have observed in practice that when establishing a hedging relationship for you-pick-'em debt an entity must make two key decisions:

1. Identify the hedged transactions as either (a) the first interest payments from any source; or (b) the interest payments on a specific debt agreement
2. Determine the amount of flexibility in interest index and interest calculation period it desires in the hedge designation by (a) designating a specific interest index and interest calculation period and asserting that it will elect only that alternative for the hedged portion of the debt;

or (b) designating a broader set of alternatives and performing additional effectiveness assessments to support that the set of alternatives will be highly effective.

Regarding the first decision, we have observed that entities apply both the first payments approach and the specific debt approach to hedge designations, with the decision driven by the population of debt the entity holds and also the expected replacement timelines in relation to the hedged time period.

The second decision is much more nuanced. A 1-month or 3-month LIBOR-indexed derivative will usually be highly effective against many of these alternative indexes and interest calculation periods. Depending on the interest rate environment, an entity could temporarily reduce its effective interest rate and thereby preserve capital by choosing a longer or shorter interest calculation period on its you-pick-'em debt. In practice we generally see two fact patterns:

1. The entity desires to fix its effective interest rate at the inception of the hedging relationship and is therefore comfortable selecting one tenor of LIBOR and rejecting all remaining alternative indexes and interest calculation periods in the debt agreement; or
2. The entity retains the flexibility to choose more than one interest rate but restricts its alternatives to only 1-month and 3-month LIBOR as designated risks.

We appreciate Example 25 in 815-30-55-158 through 55-160 because it addresses a change in the number of interest payments. However, there are numerous issues related to you-pick-'em debt and we feel practice would greatly benefit from a comprehensive example in the guidance that addresses the following issues:

- Defining the hedged transactions
- Shared risk analysis at inception and on an ongoing basis
- Effectiveness assessments at inception and on an ongoing basis

<u>Impact of a change in the number and timing of hedged cash flows</u>

Example 25 in 815-30-55-158 through 55-160 illustrates a fact pattern where the number of interest payments changes. Paragraph 815-30-55-160 further indicates that, if the forecasted interest payments are no longer probable to occur within the initial 10-year period, the entity should dedesignate the portion of the hedging instrument that is associated with the non-probable interest payments. Also, 815-20-25-45 indicates that an entity may designate all or a proportion of a hedging instrument. In practice we have observed this to mean that each cash flow must be designated in the same percentage across the term of the hedging instrument. We recommend that the Board clarify whether individual cash flows can be designated and dedesignated or whether the concept from 815-20-25-45 should be preserved.

In addition, the focus on the timing of the payment seems to be out of alignment with how interest accrues on financial instruments. In this example, it seems to be that the change in the interest period extends a payment past the end of the 10-year period of the hedging relationship by 1 or 2 months. We note that on the accrual basis of accounting, even though the interest is not paid until the end of the interest period it will be accrued and recognized in earnings during the 10-year period of the hedging relationship. We note that the interest period can change at any time in the life of the hedging relationship, and dedesignating the payments of the swap that relate to debt payments that extend beyond the original 10-year period could lead to an extended period of derivative gains and losses recognized in earnings. This outcome does not seem to provide meaningful information to readers of the financial statements.

Further, interest can be paid at the beginning or the end of an interest period. Interest that is paid at the beginning of the period is recognized in a prepaid interest account and is recognized in earnings as it accrues. In the scenario proposed in Example 25, interest that is paid at the beginning of the period could be treated differently than interest paid at the end of the period, even though the economic distinction is insignificant.

<u>Foreign exchange risk: Consider permitting the application of the revised hedged risk guidance to foreign exchange risk</u>

We believe the change in hedged risk guidance in Issue 1 of the Exposure Draft should also be applicable to all types of cash flow hedges of foreign exchange risk. We recommend that the Board remove the portions of the Proposal that scope out foreign exchange risk as well as add examples that demonstrate how the guidance could be applied. We have provided examples for consideration in the appendix to our letter related to hedges of foreign exchange risk.

We are aware of entities today that have applied 815-30-35-37A or have analogized to 815-30-55-52 through 55-56 when a change in foreign exchange risk occurred. In response to the Board's views in BC65, we suggest that entities could identify the equivalent amount of foreign currency designated by using the spot rate for the relevant currency pair as of the hedge designation date. If the hedging relationship continues to be highly effective based on the revised foreign exchange risk, we believe it should qualify for hedge accounting based on the Exposure Draft.

<u>Transition guidance for hedges of fixed or floating interest payments</u>

Paragraph 815-20-25-19B today permits an entity to designate either a benchmark rate or a contractually specified risk if it does not know at inception of the hedging relationship whether it will issue fixed rate debt or variable rate debt. The Exposure Draft removes this paragraph and instead requires the entity to refer to its best estimate each period. We recommend that the Board provide transition guidance to allow entities to amend their hedge documentation upon transition to focus on the best estimate rather than on two potential outcomes of the hedging strategy.

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

<u>Documentation of the pricing formula</u>

We are concerned that the criteria to support pricing formulas in 815-20-25-22E(c) and 25-22(d) would be very challenging for entities to support.

For spot transactions, the requirement to corroborate a pricing formula to the broader marketplace would be challenging and potentially unfeasible. It is unlikely that all contracts in a certain market are structured the same way. Even if a reasonable range of pricing formulas is permitted, it may be difficult or impossible for an entity to obtain documentation of these pricing formulas from others in the marketplace. As a result, we are concerned that the threshold to meet the pricing criteria is very high and would place undue burden on entities. We believe that those who participate in these markets regularly have institutional knowledge of the pricing mechanisms in the market.

For non-spot transactions, the requirement to corroborate that the pricing formula that determines the price also includes the contractually specified component is a very high threshold. In contracts where a pricing formula is stated, the formula typically contains an opaque adjustment factor for basis, profit, surcharges and other items. Some of the elements that go into these adjustment factors are proprietary in nature that counterparties are generally not willing to separate. We believe that entities may not be able to obtain sufficient evidence to support this threshold if they are not able to fully identify all elements of pricing.

We note that this is a different threshold than designating a contractually specified interest rate. The interest rate in a floating rate agreement is comprised of an index and a spread. There are many elements that make up the spread such as the credit worthiness of the borrower, supply and demand for debt, and profit. The guidance contained in 815-20-25-22E seems to imply a higher burden of proof than is required for a contractually specified interest rate.

Given the views expressed above, we believe that these documentation requirements are onerous and could prove inoperable in some cases. Given sufficient understanding of the markets, there is no meaningful distinction between the pricing formula in an interest coupon and a commodity purchase.

Probable physical settlement

In practice, entities often fix the basis on commodity purchases or sales through forward agreements that leave the underlying commodity price at market. The commodity price within these contracts can then be managed through derivatives or other risk management approaches. Our understanding is that these contracts typically meet the definition of a derivative but often have very little fair value due to the limited volatility of the fixed elements. Because of this, our understanding is that entities often treat them as executory contracts and do not record them as derivatives on the balance sheet.

Further, entities often do not apply the normal purchase/normal sales scope exception to these contracts because physical settlement on any single contract is not probable, even though the purchase of the commodity is probable either through other contracts or in the spot market. For example, consider an entity with a forward purchase agreement to purchase crops from a farmer. If the crop fails or does not meet the entity's quality standards, the entity will purchase the commodity on the spot market and financially settle the forward contract based on its default provisions.

In this case the entity still buys the commodity and bears the same risk related to the underlying commodity index.

To designate a contractually specified rate (since spot purchases won't have an index written down) the entity would designate the forward contract as the hedged item. The entity knows it will purchase the commodity, but usually can't assert with 80% confidence that the forward contract will physically settle.

In this case, the exposure is the same whether the entity purchases the commodity via the forward contract or a spot contract. 815-20-25-15(b) already incorporates a probability threshold to qualify for a cash flow hedge; however, 815-20-25-15B(a) creates an additional requirement that the contract must physically settle. We believe that this physical settlement requirement will be largely inoperable and will effectively prevent entities from applying hedge accounting to many non-spot commodity purchases and sales. We recommend removing 815-20-25-15B(a) from the Proposal. If it did not intend to impose a requirement that is more stringent than 815-20-25-15(b), we request that the Board clarify the intended principle.

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.

Please see our comments above regarding Issues 1 and 2.

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

Please see our comments above regarding Issues 1 and 2.

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

Please see our comments above regarding Issues 1 and 2.

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 do not believe that there are any special considerations for private companies.

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.

Please see our comments above regarding Issue 1.

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 believe the change in hedged risk guidance in Issue 1 of the Exposure Draft should also be applicable to all types of cash flow hedging relationships, including hedges of foreign exchange risk and credit risk.

However, if foreign exchange risk and credit risk are scoped out of Issue 1 additional transition guidance will be needed.

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 support the transition provisions provided in the guidance. As mentioned in our summary, we believe transition guidance is also necessary for hedging relationships where entities have applied the revised hedged risk guidance to hedges of foreign exchange and also to hedging relationships where the source of the hedged forecasted transaction is uncertain and could stem from either the issuance of a variable rate instrument or a fixed rate instrument.

Depending on the final state of the exposure draft, additional and/or different transition provisions may be required.

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 feel that there may be significant changes to systems and processes that may not be possible prior to the effective date. Entities will be working through reference rate reform and other recent accounting standards changes that will likely take priority over changes required by this Exposure Draft. We recommend extending the mandatory effective date to fiscal years beginning after December 15, 2021.

Appendix

Foreign Currency Examples – Below we include two examples that demonstrate how the revised hedged risk guidance could be applied to hedges of foreign currency risk. The difference between the two examples is that example 1 defines the hedged transactions in currency amount and example 2 defines the hedged transactions based on number of units purchased in a foreign currency. We believe both approaches should be permitted.

> > Example 1: Effect on Accumulated Other Comprehensive Income from Changes in a Cash Flow Hedge

a. An experienced shortfall in forecasted transactions with the designated hedged risk occurs in the originally specified period (Case A).
b. An experienced shortfall in forecasted transactions occurs in the originally specified period, but the shortfall is fulfilled in the two-month period thereafter (Case B).

Cases A and B share the following assumptions:

a. Entity A's functional currency is USD
b. Entity A expects to make 1,500,000 EUR-denominated equipment purchases during March 20X1
c. Entity A's best estimate of the risk expected to be present in those purchases is the EUR-USD exchange rate.
d. The EUR-GBP spot rate on the trade date of the hedging instrument is 0.77.
e. To hedge the risk of changes in those forecasted purchases attributable to the changes in the EUR-USD exchange rate, Entity A does the following:
    1. Enters into a EUR-USD currency forward contract on January 1, 20X1
    2. Documents that it is hedging the variability of the first 1,500,000 of forecasted EUR denominated purchases of equipment in March 20X1 attributable to the EUR-USD exchange rate, which is its best estimate of the hedged risk expected to be present in those purchases
    3. Documents the method that it will use to identify a hedged transaction with an undocumented hedged risk after it occurred. Entity A's method 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.
f. Throughout the hedging relationship Entity A prospectively assesses hedge effectiveness considering changes only in its best estimate of the hedged risk expected to be present in the forecasted purchases when they occur (that is, the EUR-USD exchange rate).
g. On March 31, 20X1, the hedging relationship is assessed as highly effective on the basis of Entity A's best estimate of the hedged risk throughout March 20X1 (that is, EUR-USD exchange rate).
h. Entity A has a reporting date of March 31, 20X1.

> > > Case A: An Experienced Shortfall in Forecasted Transactions with the Designated Hedged Risk Occurs in the Originally Specified Period

This Case has the following assumptions:

a. Entity A made 850,000 EUR-denominated equipment purchases during March 20X1, all of which affected earnings in April 20X1.
b. Entity A made 500,000 GBP-denominated equipment purchases during March 20X1, which would equate to 650,000 EUR based on the EUR-GBP spot rate of 0.77. Of those purchases, 400,000 of the EUR equivalent purchases affected earnings in the reporting period ended March 31, 20X1, while the remaining 250,000 of the EUR equivalent purchases affected earnings in April 20X1.
c. Entity A made 500,000 EUR-denominated equipment purchases during April 20X1.

Entity A identifies hedged forecasted transactions as follows:

a. First, EUR-denominated equipment purchases that occurred during the originally specified period indexed to the documented hedged risk (that is, the 850,000 of EUR-denominated purchases that occurred during March 20X1)
b. Second, equipment purchases that occurred during the originally specified period with an undocumented hedged risk that have not yet affected reported earnings in accordance with Entity's A method for identifying hedged transactions (that is, the 250,000 EUR equivalent of the GBP-denominated equipment purchases that occurred during March 20X1 that affected earnings in April 20X1)
c. Third, equipment purchases that occurred during the originally specified period with an undocumented hedged risk that affected reported earnings in the period ended March 31, 20X1, in accordance with Entity A's method for identifying hedged transactions but only the amount needed to fulfill the shortfall in the amount of forecasted purchases designated as hedged (that is, the 400,000 EUR equivalent of GBP-denominated equipment purchases that occurred during March 20X1 that affected earnings in the reporting period ended March 31, 20X1).

Entity A does not identify any of the €500,000 EUR-denominated equipment purchases that were purchased during April 20X1 as hedged transactions because sufficient forecasted transactions occurred during the originally specified period to fulfill the amount of forecasted transactions hedged at inception. Entity A would have identified equipment purchases that occurred during April 20X1 as hedged transactions only if there was a shortfall in equipment purchases that occurred during the hedge period (that is, March 20X1) considering all risks.

As of the March 31, 20X1 reporting date, Entity A reclassifies amounts from accumulated other comprehensive income to earnings associated with the 400,000 EUR equivalent GBP-denominated equipment purchases identified as hedged in March 20X1 and amounts associated with the 850,000 EUR-denominated equipment purchases and 250,000 EUR equivalent GBP-denominated equipment purchases, respectively, in April 20X1. The guidance in 815-30-40-5 does not apply in this Case because Entity A fulfilled the designated amount of forecasted transactions (that is 1,500,000 of equipment purchases) in the originally specified period or within the additional 2-month period of time thereafter.

> > > Case B: An Experienced Shortfall in Forecasted Transactions Occurs in the Originally Specified Period but Shortfall Fulfilled in the Two-Month Period Thereafter

This case has the following assumptions:

a. Entity A made 1,000,000 of EUR-denominated equipment purchases during March 20X1, all of which affected earnings in April 20X1.
b. Entity A made 300,000 of GBP-denominated equipment purchases during March 20X1, which would equate to 390,000 EUR based on the EUR-GBP spot rate of 0.77. Of those purchases, 300,000 of EUR equivalent purchases affected earnings in the reporting period ended March 31, 20X1, while the remaining 90,000 of EUR equivalent purchases affected earnings in April 20X1.
c. Entity A made 50,000 of EUR-denominated equipment purchases during April 20X1, all of which affected earnings in May 20X1.
d. Entity A made 250,000 of GBP-denominated equipment purchases during April 20X1, which would equate to 325,000 EUR based on the EUR-GBP spot rate of0.77 all of which affected earnings in May 20X1.

Entity A identifies hedged forecasted transactions as follows:

a. First, equipment purchases that occurred during the originally specified period indexed to the documented hedged risk (that is, the 1,000,000 of EUR-denominated equipment purchases that occurred during March 20X1)
b. Second, equipment purchases that occurred during the originally specified period with an undocumented hedged risk that have not yet affected reported earnings in accordance with Entity A's method for identifying hedged transactions (that is, the 90,000 EUR equivalent of GBP-denominated equipment purchases that occurred during March 20X1 that affected earnings in April 20X1)
c. Third, equipment purchases that occurred during the originally specified period with an undocumented hedged risk that affected reported earnings in the period ended March 31, 20X1, in accordance with Entity A's method for identifying hedged transactions (that is, the 300,000 EUR equivalent of GBP-denominated equipment purchases that occurred during March 20X1 that affected earnings in the reporting period ended March 31, 20X1)
d. Fourth, equipment purchases that occurred during the 2-month period after the originally specified period indexed to the documented hedged risk (that is, the 50,000 of EUR-denominated equipment purchases that occurred during April 20X1)
e. Fifth, equipment purchases that occurred during the 2-month period of time after the originally specified period with an undocumented hedged risk that have not yet affected reported earnings in accordance with Entity A's method for identifying hedged transactions but only the amount needed to the fulfill the shortfall in the amount of forecasted purchases designated as hedged (that is, 60,000 EUR equivalent of GBP-denominated equipment purchases that occurred during April 20X1).

As illustrated in (a) through (e), Entity A identifies hedged transactions that occurred in the two-month period of time after the original specified period only after all forecasted transactions that occurred during the hedged period, regardless of risk, are identified as hedged.

Entity A reclassifies amounts from accumulated other comprehensive income to earnings associated with the 300,000 EUR equivalent of GBP-denominated equipment purchases identified in March 20X1 and amounts associated with the 1,000,000 EUR-denominated and 90,000 EUR equivalent of GBP-denominated equipment purchases identified, respectively, in April 20X1. Lastly, Entity A reclassifies amounts from accumulated other comprehensive income to earnings associated with the 50,000 EUR-denominated and 60,000 EUR equivalent of GBP-denominated equipment purchases identified, respectively, in May 20X1. The guidance in 815-30-40-5 does not apply in this Case because Entity A fulfilled the designated amount of forecasted transactions (that is 1,500,000 EUR denominated equipment purchases) in the originally specified period plus the additional 2-month period thereafter.

> > Example 2: Effect on Accumulated Other Comprehensive Income from Changes in a Cash Flow Hedge

a. An experienced shortfall in forecasted transactions with the designated hedged risk occurs in the originally specified period (Case A).
b. An experienced shortfall in forecasted transactions occurs in the originally specified period, but the shortfall is fulfilled in the two-month period thereafter (Case B).

Cases A and B share the following assumptions:

a. Entity A's functional currency is USD
b. Entity A expects to make 100 units of equipment purchases during March 20X1, initially expected to be €1,500,000.
c. Entity A's best estimate of the risk expected to be present in those purchases is the EUR-USD exchange rate.
d. To hedge the risk of changes in those forecasted purchases attributable to the changes in the EUR-USD exchange rate, Entity A does the following:
    1. Enters into a derivative instrument (for example, an EUR-USD currency forward contract with €1,500,000 notional) on January 1, 20X1
    2. Documents that it is hedging the variability of the first 100 units of equipment purchases in March 20X1 attributable to its best estimate of the hedged risk expected to be present in those purchases, the EUR-USD exchange rate.
    3. Documents the method that it will use to identify a hedged transaction with an undocumented hedged risk after it occurred. Entity A's method 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.

e. Throughout the hedging relationship Entity A prospectively assesses hedge effectiveness only considering changes in its best estimate of the hedged risk expected to be present in the forecasted purchases when they occur (that is, the EUR-USD exchange rate).
f. On March 31, 20X1, the hedging relationship is assessed as highly effective on the basis of Entity A's best estimate of the hedged risk throughout March 20X1 (that is, EUR-USD exchange rate).
g. Entity A has a reporting date of March 31, 20X1.

> > > Case A: An Experienced Shortfall in Forecasted Transactions with the Designated Hedged Risk Occurs in the Originally Specified Period

This Case has the following assumptions:

a. Entity A made 75 units of EUR-denominated equipment purchases during March 20X1, all of which affected earnings in April 20X1.
b. Entity A made 25 units of GBP-denominated equipment purchases during March 20X1. Of those purchases, 15 units of the equipment purchases affected earnings in the reporting period ended March 31, 20X1, while the remaining 10 units of the purchases affected earnings in April 20X1.
c. Entity A made 50 units of EUR-denominated equipment purchases during April 20X1.

Entity A identifies hedged forecasted transactions as follows:

a. First, EUR-denominated equipment purchases that occurred during the originally specified period indexed to the documented hedged risk (that is, the 75 units of EUR-denominated equipment that occurred during March 20X1)
b. Second, equipment purchases that occurred during the originally specified period with an undocumented hedged risk that have not yet affected reported earnings in accordance with Entity's A method for identifying hedged transactions (that is, the 10 units of the GBP-denominated equipment purchases that occurred during March 20X1 that affected earnings in April 20X1)
c. Third, equipment purchases that occurred during the originally specified period with an undocumented hedged risk that affected reported earnings in the period ended March 31, 20X1, in accordance with Entity A's method for identifying hedged transactions but only the amount needed to fulfill the shortfall in the amount of forecasted purchases designated as hedged (that is, 15 units of GBP-denominated equipment purchases that occurred during March 20X1 that affected earnings in the reporting period ended March 31, 20X1).

Entity A does not identify any of the 50 units of EUR-denominated equipment purchases that were purchased during April 20X1 as hedged transactions because sufficient forecasted transactions occurred during the originally specified period to fulfill the amount of forecasted transactions hedged at inception. Entity A would have identified equipment purchases that occurred during April 20X1 as hedged transactions only if there was a shortfall in equipment purchases that occurred during the hedge period (that is, March 20X1) considering all risks.

As of the March 31, 20X1 reporting date, Entity A reclassifies amounts from accumulated other comprehensive income to earnings associated with the 15 units of GBP-denominated equipment purchases identified as hedged in March 20X1 and amounts associated with the 75 units of EUR-denominated equipment purchases and 10 units of GBP-denominated equipment purchases, respectively, in April 20X1. The guidance in paragraph 815-30-40-5 does not apply in this Case because Entity A fulfilled the designated amount of forecasted transactions (that is 100 units of equipment purchases) in the originally specified period or within the additional 2-month period of time thereafter.

> > > Case B: An Experienced Shortfall in Forecasted Transactions Occurs in the Originally Specified Period but Shortfall Fulfilled in the Two-Month Period Thereafter

This case has the following assumptions:

a. Entity A made 50 units of EUR-denominated equipment purchases during March 20X1, all of which affected earnings in April 20X1.
b. Entity A made 20 units of GBP-denominated equipment purchases during March 20X1. Of those purchases, 12 units of purchases affected earnings in the reporting period ended March 31, 20X1, while the remaining 8 units of purchases affected earnings in April 20X1.
c. Entity A made 25 units of EUR-denominated equipment purchases during April 20X1, all of which affected earnings in May 20X1.
d. Entity A made 18 units of GBP-denominated equipment purchases during April 20X1, all of which affected earnings in May 20X1.

Entity A identifies hedged forecasted transactions as follows:

a. First, equipment purchases that occurred during the originally specified period indexed to the documented hedged risk (that is, 50 units of EUR-denominated equipment purchases that occurred during March 20X1)
b. Second, equipment purchases that occurred during the originally specified period with an undocumented hedged risk that have not yet affected reported earnings in accordance with Entity A's method for identifying hedged transactions (that is, the 8 units of GBP-denominated equipment purchases that occurred during March 20X1 that affected earnings in April 20X1)
c. Third, equipment purchases that occurred during the originally specified period with an undocumented hedged risk that affected reported earnings in the period ended March 31, 20X1, in accordance with Entity A's method for identifying hedged transactions (that is, the 12 units of GBP-denominated equipment purchases that occurred during March 20X1 that affected earnings in the reporting period ended March 31, 20X1)
d. Fourth, equipment purchases that occurred during the 2-month period of time after the originally specified period indexed to the documented hedged risk (that is, 25 units of EUR-denominated equipment purchases that occurred during April 20X1)
e. Fifth, equipment purchases that occurred during the 2-month period of time after the originally specified period with an undocumented hedged risk that have not yet affected reported earnings in accordance with Entity A's method for identifying hedged transactions but only the amount

needed to the fulfill the shortfall in the amount of forecasted purchases designated as hedged (that is, 5 units of GBP-denominated equipment purchases that occurred during April 20X1).

As illustrated in (a) through (e), Entity A identifies hedged transactions that occurred in the two-month period of time after the original specified period only after all forecasted transactions that occurred during the hedged period, regardless of risk, are identified as hedged.

Entity A reclassifies amounts from accumulated other comprehensive income to earnings associated with 12 units of GBP-denominated equipment purchases identified in March 20X1 and amounts associated with the 50 units of EUR-denominated and 8 units of GBP-denominated equipment purchases identified, respectively, in April 20X1. Lastly, Entity A reclassifies amounts from accumulated other comprehensive income to earnings associated with 25 units of EUR-denominated and 5 units of GBP-denominated equipment purchases identified respectively, in May 20X1. The guidance does not apply in this Case because Entity A fulfilled the designated amount of forecasted transactions (that is 100 units of equipment purchases) in the originally specified period plus the additional 2-month period of time thereafter.