August 28, 2017

FASB Understanding Costs and Benefits

ASU: Derivatives and Hedging (Topic 815)

This document summarizes how the Financial Accounting Standards Board (FASB) considered the expected benefits and costs of its new Accounting Standards Update (ASU) No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities,* and the process the FASB undertook in concluding that the expected benefits of the amendments in the ASU justify the anticipated costs.

The FASB issues new financial accounting and reporting standards only when the benefits of a standard—which include improvements in the relevance and neutrality of reported financial information—justify the costs it imposes on financial statement preparers to implement the new standard and on users to become familiar with and incorporate the new information into their analyses.

The FASB concluded that the expected benefits of the amendments in this ASU justify the anticipated costs.

Extensive outreach activities were conducted with users, preparers, and auditors as part of the development of this ASU in order to better understand areas of complexity in existing guidance that could be improved and areas for which financial reporting does not provide useful information to users of financial statements.

The new requirements, which address the areas identified in outreach that needed improvement, will reduce complexity and align hedge accounting more closely with a preparer's risk management activities. Because of the closer alignment of risk management and accounting, users of financial statements will be provided with more useful information about an organization's risk management activities and their effects on the financial statements. While organizations are likely to incur costs associated with implementing the new requirements, the FASB has sought to minimize the cost of implementation and complexity based on preparer feedback.

The new standard affects all organizations that elect to apply hedge accounting; however, because hedge accounting is optional within Generally Accepted Accounting Principles (GAAP), not all organizations will bear the costs of the amendments.

The ASU on hedge accounting will take effect for public business entities in 2019. For other organizations, the ASU will take effect in 2020.

Early adoption will be permitted in any interim period for all organizations.

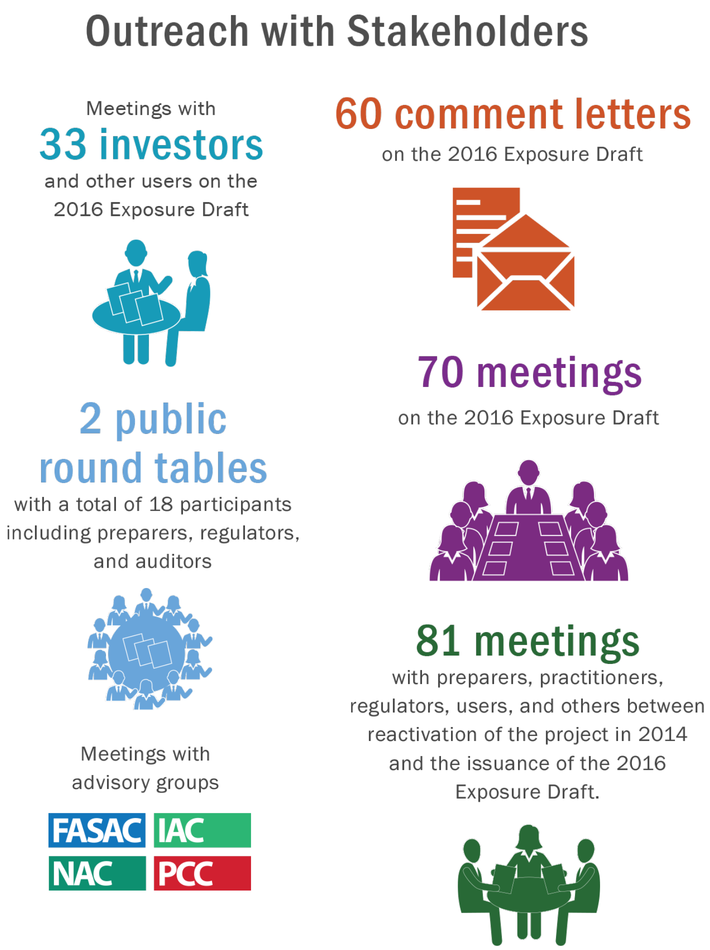
BACKGROUND

The Hedge Accounting project was added to the FASB's agenda based on feedback from preparers and users asking the Board to address a number of issues related to various aspects of hedge accounting. The main objectives of the amended standard are to provide financial statement users with more useful information about an organization's risk management activities and to reduce the complexity and operational burden of applying hedge accounting. These objectives are achieved by:

- Expanding and refining hedge accounting for nonfinancial and financial risk components
- Decreasing the complexity of preparing and understanding hedge results by eliminating the separate measurement and reporting of hedge ineffectiveness
- Enhancing transparency, comparability, and understandability of hedge results through enhanced disclosures and a change to the presentation of hedge results
- Reducing the cost and complexity of applying hedge accounting by simplifying the way assessments of hedge effectiveness may be performed.

OUTREACH WITH STAKEHOLDERS

Since the hedging project was reactivated in 2014, the FASB conducted extensive outreach activities and received significant input from a wide variety of stakeholders. The outreach activities undertaken by the FASB to develop the ASU are depicted below:



STAKEHOLDER CONCERNS

The common message received through outreach meetings was that current hedge accounting guidance does not mirror an organization's risk management activities. Commonly cited issues included the following:

- Organizations are not allowed to hedge a component of a nonfinancial item, such as a commodity price component linked to an index.
- For some risk management strategies, hedge accounting is allowed but the mechanics of hedge accounting require an organization to record ineffectiveness that does not reflect the economics of the risk management activity.
- For some risk management strategies, fair value hedge accounting is theoretically allowed but not operable.
- Users have a difficult time understanding hedge accounting results in part due to hedge ineffectiveness and the lack of cohesive presentation of all hedge accounting results in the income statement.

The FASB considered these concerns when developing the new ASU to ensure it fills a significant need and that the costs are justified in relation to the overall benefits.

COSTS: APPLYING THE NEW ASU

The FASB understands that reporting organizations that elect to apply hedge accounting will incur additional costs as a result of the new ASU.

For example, organizations will, in general, incur initial costs to educate employees about how to apply the new requirements and to explain to users the effects of the changes in hedge accounting on the organization's financial statements.

In addition, many organizations may need to consider changes to systems and processes to ensure that they are applying hedge accounting in accordance with the new standard.

However, once these implementation activities are complete and an organization's systems and processes have been fully updated, the ongoing costs for most organizations of applying hedge accounting under the new ASU should be lower than the costs of complying with the hedge accounting model in current GAAP. This is because of the various amendments in the new ASU that are intended to reduce the cost and complexity of applying hedge accounting.

BENEFITS: APPLYING THE NEW ASU

The FASB observed that the new ASU will provide benefits to many investors and other users of financial statements by increasing the transparency of information provided on risk management activities. More specifically, the new ASU accomplishes the following:

- Expands and refines risk component hedging for nonfinancial and financial risks for preparers to more accurately present, and users to better understand, an organization's risk exposures and risk management activities
- Eliminates the separate measurement and reporting of hedge ineffectiveness that has resulted in complexity in the financial reporting process and hindered the usefulness of reported information
- Aligns the financial reporting for hedges of interest rate risk with the economic results of those risk management activities
- Reduces the costs and complexity of monitoring the effectiveness of a hedging relationship by allowing more qualitative assessments
- Allows more time for the preparation of hedge documentation for preparers that elect hedge accounting.

Summary: Overview of Costs and Benefits of the New Hedge Accounting Standard

FOR ORGANIZATIONS THAT ELECT TO APPLY HEDGE ACCOUNTING	
BENEFITS	**COSTS**
Expanding and refining risk component hedging for nonfinancial and financial risks Eliminating the separate measurement and presentation of hedge ineffectiveness Aligning the financial reporting for hedges of interest rate risk with the economic results of those risk management activities Allowing qualitative assessments for more hedging relationships Allowing more time for the preparation of hedge documentation.	Implementation costs: • Costs to educate employees about how to apply the amendments and how to explain to users the effects of the changes to the financial statements • Costs to update systems and processes to implement the amendments. Once implementation activities are complete and an organization's systems and processes have been fully updated, the ongoing costs associated with applying the new guidance likely will be lower than the costs of applying current GAAP.

CONCLUSION

The FASB's assessment of the costs and benefits of issuing this ASU is unavoidably more qualitative than quantitative because there is no identified method to objectively quantify all costs to implement the new guidance or to quantify the value of improved information in financial statements.

Overall, the FASB concluded that the expected benefits of the amendments in the new ASU justify the anticipated costs.

More information on the ASU, including a press release, *FASB in Focus*, and a video, can be found on the FASB website.

The views expressed in this document do not necessarily reflect the views of the FASB. Official positions of the FASB are arrived at only after extensive due process and deliberation.

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