

**Emerging Issues Task Force  
Agenda Report  
November 27, 2012 Agenda Decisions**

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**Emerging Issues Task Force Agenda Committee  
Decisions on Potential New Issues  
Discussion Date: November 27, 2012**

**1. Accounting for Investments in Tax Credits**

**Background**

1. The Low Income Housing Tax Credit (LIHTC or affordable housing tax credit) is a program designed to encourage investment of private capital for use in the construction and rehabilitation of low income housing. The program is an indirect tax subsidy that allows third-party investors to receive the benefits of the tax credits allocated to an entity that owns the affordable housing tax credit property. The LIHTC was enacted under Section 42 of the Internal Revenue Code (IRC) in 1986 and made permanent by the Revenue Reconciliation Act of 1993. The program has become one of the most successful government-sponsored housing programs in history and has grown to nearly \$8 billion in tax credits.<sup>1</sup>

2. Investments in other tax credit programs, such as the New Market Tax Credit (NMTC), the Historic Tax Credit (HTC), and the Renewable Energy Investment Tax Credit (REITC), use similar models as a way to encourage investment for strategic and economic development purposes. The NMTC program is designed to support Qualified Active Low-Income Community Businesses that operate in low-income communities. The HTC program is designed to provide incentives for the rehabilitation of historic structures towards productive use. The REITC program is designed to provide incentives for investments in qualifying renewable energy properties.

3. The LIHTC and other tax credit programs have resulted in a specific category of equity investments referred to as tax credit investments. Tax credit investments have different risks and rewards than traditional equity investments. Generally, the investor in a tax credit investment has much less participation in the underlying operating cash flows and appreciation than a traditional equity investor. Investors in a tax credit investment seek a majority of their return through the receipt of tax credits and other tax benefits. Accordingly, the principle risk associated with tax credit investments is potential noncompliance with the tax code requirements resulting in

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<sup>1</sup> Source: U.S. Department of Housing and Urban Development (HUD).

unavailability or recapture of the tax credits (for example, failure to rent property to qualified tenants under the LIHTC may result in loss of tax credits).

4. Investments in the LIHTC and other tax credit programs can be made either as direct investments with ownership in the operating entity (lower tier) or as indirect investments using an intermediary entity (upper tier). The focus of this issue would be on the lower tier level investments. It is assumed that this issue would consider investments at both the lower tier level and the upper tier level.

5. In a typical LIHTC investment, the tax credits are allowable on the investor's tax return each year over a 10-year period as a result of renting a sufficient number of units to qualifying tenants. However, those credits are subject to recapture over a 15-year period starting with the first year tax credits are earned. Investors receive the benefits of the tax credits by making an equity investment as a limited partner in the entity that owns the underlying affordable housing property.

6. Current accounting guidance, with one limited exception (that is, the effective yield method), treats tax credit investments in the same manner as traditional equity investments, primarily because of their structure. That is, tax credit investments are generally treated as equity method investments. Most investors apply the equity method of accounting because the investors don't meet the consolidation requirements through their limited partnership interests, but have significant influence. Alternative methods of accounting include the cost method or the fair value method (when the investor has elected the fair value option of accounting.)

7. An alternative method known as the "effective yield method" can be used if the investors meet certain criteria under EITF Issue No. 94-1, "Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects" (Codified in Subtopic 323-740, Investments—Equity Method and Joint Ventures—Income Taxes), the primary guidance related to accounting for affordable housing tax credit investments. When developing Issue 94-1, the Task Force discussed whether LIHTC investments were more similar to investments in real estate or receivables. The Task Force concluded that LIHTC investments were more like real estate

investments and should be accounted for in accordance with AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures* (Codified in Topic 970, Real Estate—General). According to Topic 970, a limited partner should use the equity method of accounting to account for its interest in the partnership unless the interest is so minor as to have virtually no influence over partnership operating and financial policies. The Task Force, however, considered LIHTC investments in partnerships that have a positive yield based solely on tax credits and a third-party guarantee, to be different and allowed such investments to be accounted for using the alternative method of accounting, the effective yield method.

8. Subsequently, in EITF Issue No. 98-11, "Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations," the Task Force reaffirmed that purchases of future tax benefits should be accounted for as an investment using the effective yield method. The Task Force did not modify or expand the application of the effective yield method under Issue 94-1 for LIHTC investments.

9. The equity method of accounting for investments in tax credits results in the separate reporting of the investment performance and the tax credits, whereby the investment performance is reported within pre-tax income and the tax credits within the after-tax (net) income. In LIHTC investments, because the tax credits are not reflected as a component of the investment's performance, this often results in pre-tax losses being reported despite the investment performing as intended and yielding an after-tax net benefit to the investors. All alternative methods of accounting (except the effective yield method) result in a similar (gross up) presentation in the income statement.

10. The effective yield method is the one exception to the requirement to separately report pre and post tax investment performance. Under the effective yield method, the net benefits are included as a component of the investor's tax provision. The amount of net benefits is recognized within the tax provision as a constant yield on the carrying value of the net investment as the tax credits are received. That is, in general, there are no pre-tax losses recognized in the financial statements for investments that qualify for the effective yield method.

11. However, among tax credit investments, the effective yield method only applies to the LIHTC, and only a small portion of the LIHTC investments meet the criteria under Issue 94-1 to qualify for the effective yield method. One of the most restrictive criteria that must be met for an investment to qualify is that the amount of the tax credits must be guaranteed by a creditworthy guarantor. While no specific guidance is provided regarding what types of entities would be considered creditworthy guarantors, the guidance makes reference to such guaranties being similar to a letter of credit or tax indemnity agreement, which has been interpreted as a high threshold of creditworthiness. The rationale for the creditworthy guarantor requirement is based on the uncertainty related to the availability of the tax credits. Another criterion that can be restrictive is that the projected yield of the investment has to be positive based solely on the cash flows from the guaranteed tax credits. Investors generally view yield as a combination of all cash inflows from the investment, including tax credits and other tax benefits (such as tax losses reported by the partnership that flow up to the investor.) Yields based solely on tax credits generally have declined since the credit's inception as a result of the lower risk profile of these investments. Accordingly, it is not always possible for the investor to meet the relevant criterion to qualify for the effective yield method.

12. The result is that most investments in the LIHTC and other tax credit investment programs are accounted for under the equity method of accounting. Some believe that the resulting presentation in the income statement of the pre-tax investment performance separately from the tax benefits distorts investment performance by reporting pre-tax losses on otherwise profitable investments, and makes investment performance difficult to understand.

### **Scope Alternatives**

13. There is currently no accounting guidance for tax credit investments that are not related to the LIHTC. Accordingly, this issue can be limited to LIHTC, only, or can encompass all tax credit investments.

*View A: The scope of this issue should be limited to accounting for limited partnership interests in a qualified affordable housing project.*

14. Proponents of View A believe that limiting the scope of this issue to only include LIHTC investments will result in a possibly quicker response by the Task Force to the various concerns in practice with respect to the income statement presentation of those investments. Because there is existing guidance in Issue 94-1, the proponents of this view believe that the Task Force would have the ability to revisit the conclusions of that consensus to determine whether modifications are necessary to the criteria for applying the effective yield method.

15. Opponents of View A state that tax credits in other areas are continually growing and the current economic environment creates uncertainty with respect to the future of the various tax credits. Accordingly, it would be difficult to predict which tax credits will survive and which ones will disappear. They believe that if the scope is limited to only one type of tax credit, a consensus may be reached sooner; however, that consensus may also become obsolete sooner due to potential changes in tax policy. Additionally, limiting the scope of the issue to only one tax credit would potentially increase inconsistency in the reporting of different tax credit investments with similar objectives and structures.

*View B: The scope of this issue should apply to all forms of investments in tax credit.*

16. Proponents of View B believe that a broader scope would be more flexible to future changes in tax policy. In addition, they believe that other tax credits are similar enough to the LIHTC in their objectives, such that the Task Force could come up with principles that govern accounting for all tax credits. Most of those investments are structured as equity investments with the objective of providing a majority of the investment returns in the form of tax benefits. Similar to affordable housing tax credit investments, other tax credit investors generally do not have any significant participation in the operations of the investee.

17. An expanded scope would require further analysis of the different types of credits, comparing and contrasting their objectives, and identifying potential implications of allowing such investments to be accounted for using the effective interest method. Opponents of View B believe that such a broad scope would require the EITF to invest a substantial amount of time to explore all viable options and consequences. Opponents of View B further state that there are

variations to how the different tax credit investments are structured that may complicate the accounting, if the scope were to include all tax credits.

18. Opponents of View B also assert that the more prescriptive the Task Force is in providing guidance, the more difficult it would be to apply the guidance to all tax credit investments because each tax credit would potentially have to be considered in developing the prescriptive guidance and/or criteria. In other words, an expanded scope to all tax credit investments would likely require highly principle-based guidance, necessitating significant judgment in the application of such guidance. In addition, the expanded scope would potentially require that the Task Force define a "tax credit investment" such that it can be distinguished from investments with other tax attributes. Due to the potential challenges associated with developing overarching principles and defining tax credit investments, some opponents prefer that the Task Force answer the question for LIHTC investments only, and then allow companies to apply the guidance resulting from this issue to similar transactions by analogy, in accordance with guidance in paragraph 105-10-05-2.

19. Proponents of View B agree that tax credit investments would need to be defined, however they state that providing such a definition could be as simple as stating that the investment allows investors to obtain tax benefits as a result of an ownership interest in the limited partnership and that obtaining the tax benefits is a significant reason for making the investment.

### **Accounting Issue and Alternatives**

#### **How an investor should account for an investment in tax credits within the scope of this issue.**

*View A: Reaffirm the consensus reached in Issue 94-1 for investments in tax credits within the scope of this issue.*

20. Under View A, LIHTC investments (and, potentially other tax credit investments) would be treated as investments in a limited partnership to be accounted for in accordance with Subtopic 970-323, Real Estate—General—Investments—Equity Method and Joint Ventures, which

requires the use of the equity method of accounting for limited partnership investments unless the limited partner's interest is so minor as to give the partner virtually no influence over partnership operating and financial policies.

21. An investor can elect to apply the effective yield method if all of the following criteria, consistent with current guidance, are met:

- a. The availability (but not necessarily the realization) of the tax credits allocable to the investor is guaranteed by a creditworthy entity through a letter of credit, a tax indemnity agreement, or another similar agreement
- b. The investor's projected yield based solely on the cash flows from the guaranteed tax credits is positive
- c. The investor is a limited partner in the project for both legal and tax purposes and the investor's liability is limited to its capital investment.

23. Proponents of View A believe that the qualifying threshold for the effective yield method should remain high, such that only those investors with virtually no risk of economic loss qualify for the treatment. They believe that a guarantee by a creditworthy entity would in most cases be necessary for reducing the risk of economic loss to an acceptably low level. The proponents of this view also are concerned that if the criteria are modified to be less restrictive, it would become difficult to separate tax credit investments from other investments that generate significant tax benefits, for example, due to accumulated net operating losses.

*View B: Enhance disclosures for tax credit investments to provide information about the effect of a tax credit investment on the investor's income statement.*

24. Proponents of View B believe that disclosures should be improved to eliminate confusion about the investment's performance without changing the underlying accounting. They believe that disclosures would include information about the gross and net investment performance, including the effect of tax credits and other tax-provision-related benefits. Proponents of View B state that such disclosures could be provided by extracting selected portions of investment

performance and portions of the income tax provision to reflect the economic effect of the tax credit investments.

25. Opponents of View B state that, under this alternative, pretax income would continue to include the investment's pretax operating losses, potentially resulting in the same perception of the investment (as a loss generating investment) that exists today. Therefore, while improved disclosures might help users better understand a company's tax credit investments it would not adequately address the classification and presentation issue for those investments.

*View C: Expand the use of the effective yield method for investments in tax credits within the scope of this issue.*

26. Proponents of View C believe that the criteria for the effective yield method of accounting should be amended such that a greater number of tax credit investments qualify for the method. Since the Task Force addressed the accounting for LIHTC investments under Issue 94-1, investments in tax credits have significantly grown. Investment structures have also evolved, whereby most investments do not provide the investor with any significant participation in operation, cash flows, or residual values of the underlying property. The perceived risk level of those investments has also decreased considerably after years of demonstrated receipt of tax benefits by investors and as evidenced by the lower yields. Consequently, proponents of this alternative believe that the industry has outgrown the current guidance, and therefore the criteria in Issue 94-1 should be replaced with principles that appropriately distinguish tax credit investments from other equity investments in real estate. For example, principles can be developed such that the effective yield method is appropriate when an investor's projected benefits that are not from tax credits (or from other tax benefits) are insignificant in relation to total returns from the investment. As such, investments would qualify only when they are structured in a manner whereby the investor has primarily protective rights and has only insignificant rights to receive benefits other than the tax credits (or other tax benefits.)

27. Proponents of View C believe that another potential way to expand the use of the effective yield method of accounting would be to define which tax credit investments would *not* qualify

for the effective yield method. For example, investments in tax credits structured in a manner in which the investor retains significant operational influence and has significant rights to receive benefits other than from the tax credits (and from other tax benefits) would be indicative of an investment that is in substance an equity investment in an operating entity and not a tax credit investment.

28. Proponents of View C further state that investments in tax credits are different from investments in an operating entity. Investors who make limited partnership investments in an operating entity do so primarily to earn a profit on their investment from the real estate. That profit is provided by the cash flows generated from operations and from appreciation of the assets held by the limited partnership, such as real estate. By design, investors in tax credits generally do not look to the cash flows of the underlying assets, such as real estate, or their eventual disposition for their investment return. Rather, their investment return is based primarily on the receipt of tax credits (and other tax benefits) resulting from their investments.

29. As a result, proponents of View C believe that the equity method of accounting does not accurately measure and classify the performance of investments in which the investee's operations have little relevance or affect on the investment. Once non-cash depreciation charges are recognized, most tax credit investments report net losses in their financial statements. The equity method of accounting distorts investment performance because the pre-tax losses are reported when the investment is performing as intended and is generating post-tax benefits.

30. Proponents of View C further state that equity method accounting causes the operating performance of the investments to be negatively perceived by users of the investor's financial statements. Some investors attempt to explain the accounting by providing non-GAAP disclosures outside the basic financial statements. Other investors only invest in affordable housing tax credit investments that qualify for the effective yield method, electing to pay a significant premium for a guarantee that will provide them with the preferred accounting result.<sup>2</sup>

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<sup>2</sup> In an article by Leslie A. Robinson, Dartmouth College, "Do Firms Incur Costs to Avoid Reducing Pre-Tax Earnings? Evidence from the Accounting for Low-Income Housing Tax Credits," it was noted that investors pay, on average, 15.8 percent of their total investment for the guarantee.

31. Opponents of View C state that limited partnership interests in an entity that holds real estate and operates that real estate should be treated in most cases as an equity investment regardless of the nature of the investor returns. Therefore, opponents of this view argue that the qualifying threshold for the effective yield method should remain high, such that only those investors with virtually no risk of economic loss qualify for the effective yield treatment. They believe that a guarantee by a creditworthy entity would in most cases be necessary for reducing the risk of economic loss to an acceptably low level. The opponents of this view also are concerned that if the criteria are modified to be less restrictive, it would become difficult to separate tax credit investments from other investments that generate significant tax benefits.

**Agenda Decision:** *This issue was added to the EITF agenda. Consistent with paragraph 323-740-05-2, the scope of the Issue would be limited to investments in limited partnerships that operate qualified affordable housing projects.*

## **2. Accounting for Income Taxes in Interim Periods**

### **Background**

1. The recognition approach in Subtopic 740-270, Income Taxes—Interim Reporting, requires entities to recognize income tax expense (or benefit) in interim periods related to ordinary income (or loss) by applying an estimated annual effective tax rate to consolidated year-to-date ordinary income (or loss). For items that are discretely recognized, a tax benefit (or loss) is individually computed and recognized when such items occur.

2. In circumstances in which (a) some of the operations of an entity are taxable and some are nontaxable or the entity operates in jurisdictions that have significantly different income tax rates, and (b) the composition of income (or loss) among nontaxable and taxable operations or jurisdictions varies significantly during interim periods, the amount of the income tax expense (or benefit) recognized in an interim period may be significantly different from the actual amount of income taxes incurred for the interim period. Such differences may be more apparent for reporting entities that ordinarily do not pay income taxes and have one or more subsidiaries that are subject to income taxes, such as, real estate investment trusts (REITs), Timber REITs, and public limited partnerships with substantive nontaxable operations and taxable subsidiaries.

3. The following example illustrates the financial reporting consequences of the circumstances described above. Timber REITs, which own and manage timberland portfolios primarily for the production and sale of timber, generally distribute earnings to shareholders without paying corporate income taxes if they meet certain requirements in the Internal Revenue Code. However, Timber REITs are subject to corporate income taxes on certain gains on sales of real property and may have taxable subsidiaries. Income between the nontaxable and taxable operations of Timber REITs commonly varies during interim periods. Consequently, there may be a significant difference between the annual effective tax rate and interim income taxes as a percentage of interim taxable income, as illustrated by the following analysis.

#### Calculation of annual effective tax rate

|                    | Estimated<br>pre-tax<br>income | Tax rate | Estimated<br>income taxes |
|--------------------|--------------------------------|----------|---------------------------|
| Nontaxable parent  | 180                            | 0%       | -                         |
| Taxable subsidiary | 120                            | 35%      | 42                        |
| Total              | 300                            |          | 42                        |

|                           |     |
|---------------------------|-----|
| Annual effective tax rate | 14% |
|---------------------------|-----|

#### Application of annual effective tax rate to interim periods

|                                   | Q1  | Q2   | Q3  | Q4  | Total |
|-----------------------------------|-----|------|-----|-----|-------|
| Nontaxable parent pre-tax income  | 100 | 50   | 20  | 10  | 180   |
| Taxable subsidiary pre-tax income | 50  | (10) | 20  | 60  | 120   |
| Total pre-tax income              | 150 | 40   | 40  | 70  | 300   |
| Annual effective tax rate         | 14% | 14%  | 14% | 14% | 14%   |
| Income tax expense                | 21  | 6    | 6   | 10  | 42    |

|                                     |     |      |     |     |     |
|-------------------------------------|-----|------|-----|-----|-----|
| Income tax expense % taxable income | 42% | -56% | 28% | 16% | 35% |
|-------------------------------------|-----|------|-----|-----|-----|

### Scope

4. This issue applies to all entities.

### Accounting Issue and Alternatives

#### **How an entity should recognize income taxes in interim periods.**

*View A: An entity should recognize interim income taxes in accordance with existing U.S. GAAP. Under Subtopic 740-270, the tax (or benefit) related to ordinary income (or loss) should be computed at an estimated annual effective tax rate and the tax (or benefit) related to all other items should be individually computed and recognized when the items occur. If an entity is unable to estimate a part of its ordinary income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported.*

5. Proponents of View A believe that the current approach is widely understood and applied consistently in practice. In addition, they believe that View B, as described below, would increase costs for many entities without providing a clear enhancement to interim financial reporting for many entities.

6. Proponents of View A believe that the interim disclosure requirements for income taxes should provide users of financial statements with sufficient information when the circumstances described above in paragraph 2 exist. The guidance is found in paragraph 740-270-50-1 and is as follows:

Application of the requirements for accounting for income taxes in interim periods may result in a significant variation in the customary relationship between income tax expense and pretax accounting income. The reasons for significant variations in the customary relationship between income tax expense and pretax accounting income shall be disclosed in the interim period financial statements if they are not otherwise apparent from the financial statements or from the nature of the entity's business.

7. Proponents of View A observe that the question of whether interim income taxes should be computed at a level lower than consolidated income (or loss) was previously considered by the FASB and rejected for all but a few instances when FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*, was deliberated. Paragraph 83 of Interpretation 18 states:

Many respondents stated that the intent of Opinion No. 28 was to apply one overall estimated annual effective tax rate to "ordinary" income for the consolidated reporting entity. Several respondents stated that interrelationships between jurisdictions would make the use of separate rates impractical. Paragraph 22 was modified to indicate that one overall estimated annual effective tax rate shall be used with the two exceptions described in that paragraph and discussed further in paragraphs 84 and 85 below.

8. Opponents of View A question whether the recognized liability or asset resulting from a difference between the annual effective tax rate and income taxes actually incurred in an interim period meets the definition of a liability or asset under FASB Concepts Statement No. 6,

*Elements of Financial Statements.* The following are excerpts from Concepts Statement 6 on the definition of a liability and asset:

Paragraph 36: A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened.

Paragraph 26: An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

9. Opponents of View A question whether calculating interim income taxes in accordance with current U.S. GAAP provides decision-useful information to users of financial statements in the circumstances described in paragraph 2 above. They believe that the results may be confusing to users when there are significant fluctuations in interim period income taxes as a percentage of taxable income.

*View B: An entity should recognize interim income taxes by separately estimating the average annual effective income tax rate for each taxing jurisdiction and applying that rate individually to the interim period pre-tax income of each jurisdiction. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable, a separate rate would be applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases and a weighted average of rates across jurisdictions or across categories of income would be used if it is a reasonable approximation of the effect of using more specific rates.*

10. Proponents of View B believe that the amount of income taxes recognized in interim periods under View B may more faithfully represent the amount of income taxes incurred in the interim

periods than under View A. In addition, they believe that the amount of income tax liabilities and assets reported in interim balance sheets would more closely align with the amounts that would be recorded based on the definitions of liabilities and assets under Concepts Statement 6.

11. Proponents of View B believe that the approach is an opportunity to improve financial reporting while converging with IFRSs, since International Accounting Standard 34, *Interim Financial Reporting*, allows entities to use the approach described in View B. In addition, proponents of View B observe that there has been a recent upward trend in the number of REITs in the U.S., which they believe may be a reason to reconsider the U.S. GAAP for accounting for interim income taxes.

12. Opponents of View B are concerned that such an approach of calculating interim period income taxes would increase costs because it requires a more detailed calculation than View A. They observe that many SEC registrants believe that the interim reporting deadline for filing a Form 10-Q with the SEC (typically 40 to 45 days) already is challenging and requiring a more detailed calculation for interim income taxes would increase that challenge. These opponents also question whether a change is warranted when improvement in the information would not be significant in many circumstances but would increase costs in many circumstances.

13. Opponents of View B believe that it could result in a volatile consolidated effective income tax rate for interim periods even though the annual rate is reasonably consistent from year to year, and they question whether the volatility in the rate would provide decision-useful information to users of financial statements.

**Agenda Decision:** *This Issue was not added to the EITF agenda.*

### **3. Presentation of a Liability for an Unrecognized Tax Benefit When a Net Operating Loss or Tax Credit Carryforward Exists**

#### **Background**

1. In certain circumstances, the settlement of a liability for an unrecognized tax benefit does not result in a cash payment because it is settled by reducing a net operating loss (NOL) carryforward. U.S. tax law requires that an entity's taxable income be reduced by available NOL carryforwards and carrybacks. The IRS cannot require a taxpayer to settle a disallowed uncertain tax position in cash if sufficient NOLs or other tax carryforwards are available to eliminate the additional taxable income. In addition, the IRS does not permit a taxpayer to choose when to use its NOLs; the taxpayer is required to use NOLs in the first year taxable income arises.

2. Topic 740, Income Taxes, does not include explicit guidance on whether and when an entity should present a liability for an unrecognized tax benefit as a liability (hereafter referred to as "gross presentation") or as a reduction of NOLs or tax credit carryforwards related to the same jurisdiction (hereafter referred to as "net presentation"). The FASB staff previously received technical inquiries on whether gross or net presentation is appropriate. The FASB staff's responses, which are not authoritative U.S. GAAP, were that the presentation of the liability for an unrecognized tax benefit depends on the relationship between the unrecognized tax benefit and the NOLs. If the liability for an unrecognized tax benefit is directly associated with a tax position taken in a tax year that results or resulted in the recognition of an NOL for that year (and the NOL has not yet been utilized), net presentation is appropriate; otherwise, gross presentation is appropriate.

3. Although a majority of entities appear to present the unrecognized tax benefit consistent with the FASB staff's responses to the aforementioned technical inquiries, there appears to be some diversity in practice due to the absence of explicit guidance within the U.S. GAAP.

#### **Accounting Issue and Alternatives**

**Whether and when an entity should present a liability for an unrecognized tax benefit in the statement of financial position on a gross or net basis.**

*View A: An entity should present a liability for an unrecognized tax benefit in the statement of financial position on a net basis when the unrecognized tax benefit and NOL relate to the same jurisdiction.*

4. Proponents of View A believe that the tax provision should be prepared as if the uncertain tax position was not claimed in the tax return. In the absence of any uncertain tax positions, an entity that generates taxable income, but has NOL carryforwards available to offset any taxes payable, would not recognize a payable under the general provisions of Topic 740. Instead, it would reduce deferred tax assets as tax expense is incurred. Proponents believe that this same principle should be applied when liabilities related to tax uncertainties are recognized. That is, if amounts were settled with the taxing authority on the basis recognized and measured, the position's resolution effectively amounts to additional taxable income. The NOL can be applied to the liability if the uncertain tax position is not sustained and the liability related to the uncertain tax position will not result in a payment of taxes but instead will reduce the NOL carryforward. Proponents believe that View A is consistent with the guidance in paragraph 740-10-25-16, which states the following:

The amount of benefit recognized in the statement of financial position may differ from the amount taken or expected to be taken in a tax return for the current year. These differences represent unrecognized tax benefits. A liability is created **(or the amount of a net operating loss carryforward or amount refundable is reduced)** for an unrecognized tax benefit because it represents an entity's potential future obligation to the taxing authority for a tax position that was not recognized under the requirements of this Subtopic. [Emphasis added.]

5. Proponents of View A believe that presenting an unrecognized tax benefit on a gross basis creates two inconsistent assertions within the financial statements. First, under U.S. tax law, accrual of interest expense is not required for unpaid tax obligations as long as the taxpayer is able to offset the exposures with NOLs within the same jurisdiction and no cash payment will be remitted to the taxing authority. Therefore, entities with NOL carryforwards are not required to accrue interest on its uncertain tax positions under Topic 740. Proponents of View A believe that the non-accrual of interest is contradictory to gross presentation of the liability. Second, in assessing the realizability of deferred tax assets under Topic 740, entities may consider the

unrecognized tax benefit liability as a source of taxable income when the entity has the ability and intent to offset the liability against the NOL.

6. Subtopic 210-20, Balance Sheet—Offsetting (formerly FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*), addresses whether and in what circumstances it is appropriate to setoff assets and liabilities in the statement of financial position. Paragraph 210-20-45-1 provides the following four conditions that must be met for a right of setoff to exist:

- a. Each of two parties owes the other determinable amounts.
- b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
- c. The reporting party intends to set off.
- d. The right of setoff is enforceable at law.

7. Proponents of View A believe that liabilities related to unrecognized tax benefits and NOL carryforwards satisfy the conditions of paragraph 210-20-45-1 for net presentation. The IRS cannot require a taxpayer to settle a disallowed uncertain tax position in cash if sufficient NOLs or other tax carryforwards are available to eliminate the additional taxable income; therefore, the right, the intention, and the enforceability of the entity to setoff exists.

8. Proponents of View A believe that the net presentation is consistent with the overall presentation requirements in Topic 740, which require net presentation of deferred tax assets and liabilities by jurisdiction.

9. Proponents of View A note the feedback the FASB received from users of financial statements in its recent project on balance sheet offsetting (FASB Accounting Standards Update No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*). Users of financial statements did not have a universal view on whether gross or net presentation in the statement of financial position was preferable, but they agreed that both gross and net information are useful and necessary to analyze the financial statements. They also welcomed quantitative disclosures in a tabular format. Because paragraph 740-10-50-15A requires a public entity to disclose a rollforward of its unrecognized tax benefits, proponents of View A believe

that the net presentation in the statement of financial position accompanied by the existing gross disclosure requirements would be consistent with views that users of financial statements recently expressed to the FASB.

10. Opponents of View A believe that the accounting policies of a majority of entities are consistent with View B, and they do not believe the costs to change financial reporting for a majority of entities is worthwhile when users of financial statements may not have a clear preference.

*View B: An entity should present a liability for an unrecognized tax benefit in the statement of financial position on a gross basis unless the unrecognized tax benefit is directly associated with a tax position taken in a tax year that results or resulted in the recognition of an NOL for that year (and such an NOL has not yet been utilized).*

11. Proponents of View B agree with the FASB staff's interpretation of gross versus net presentation, which is consistent with View B, and they believe that a majority of entities present unrecognized tax benefits consistent with View B. Proponents believe that the presentation may not be significant to users of financial statements, especially considering the aforementioned disclosure requirements for unrecognized tax benefits for public entities. They also believe that any change to current practice would not result in significant improvement to the financial reporting of an entity's unrecognized tax benefits. Consequently, they do not believe that the cost to change financial reporting for a majority of entities is worthwhile.

12. Proponents of View B believe that the approach is consistent with the guidance in paragraph 740-10-45-11, which states the following:

An entity that presents a classified statement of financial position shall classify a liability associated with an unrecognized tax benefit as a current liability (or the amount of a net operating loss carryforward or amount refundable is reduced) to the extent the entity anticipates payment (or receipt) of cash within one year or the operating cycle, if longer. **The liability for unrecognized tax benefits (or reduction in amounts refundable) shall not be combined with deferred tax liabilities or assets.** [Emphasis added.]

13. Opponents of View B believe that an unrecognized tax benefit and NOL typically meet the criteria for netting under Subtopic 210-20, particularly in the U.S. where this would be the case by operation of U.S. tax law. Opponents also observe that net presentation is consistent with the overall presentation requirements in Topic 740.

**Agenda Decision:** *This Issue was added to the EITF agenda.*

#### **4. Inclusion of the Fed Funds Rate as a Benchmark Interest Rate for Hedge Accounting Purposes**

##### **Background**

1. Topic 815, Derivatives and Hedging, provides guidance on the risks that are permitted to be hedged in a fair value or cash flow hedge. Among those risks for financial assets and financial liabilities is the risk of changes in a hedged item's fair value or a hedged transaction's cash flows attributable to changes in the designated benchmark interest rate (referred to as interest rate risk).

2. Topic 815, Derivatives and Hedging, defines a benchmark interest rate as:

A widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions.

In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate.

3. Paragraph 815-20-25-6A further defines a benchmark interest rate by stating:

In the United States, currently only the interest rates on direct Treasury obligations of the U.S. government and, for practical reasons, the London Interbank Offered Rate (LIBOR) swap rate<sup>1</sup> are considered to be benchmark interest rates. In each financial market, only the one or two most widely used and quoted rates that meet these criteria may be considered benchmark interest rates. The Fed Funds rate, the Prime rate, the Federal National Mortgage Association (FNMA or Fannie Mae) Par Mortgage rate, and the Securities Industry and Financial Markets Association Municipal Swap Index (formerly called the Bond Market Association index) shall not be used as the benchmark interest rate in the United States.

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<sup>1</sup> The Codification defines LIBOR Swap Rate as the fixed rate on a single-currency, constant-notional interest rate swap that has its variable-rate leg referenced to the London Interbank Offered Rate (LIBOR) with no additional spread over LIBOR on that variable-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equate to the present value of the variable cash flows.

4. In defining the benchmark interest rate in Topic 815, the FASB was providing a practical means to designate the risk of changes in the risk-free rate as the hedged risk, with any spread above that rate considered credit risk. As described in the basis for conclusions to FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, the Board decided that in the U.S., the interest rate on direct Treasury obligations of the U.S. government (UST) provides the best measure of the risk-free rate. Thus, the Board considered defining interest rate risk based only on UST in the U.S.

5. However, the Board decided to make an exception and extend the definition of interest rate risk to include interest rate swap rates based on LIBOR given its understanding that:

- a. LIBOR-based interest rate swaps are the most commonly used hedging instruments in the U.S. financial markets in hedges of interest rate risk.
- b. There are technical factors (such as supply and demand) that may affect the rates on direct obligations of any single issuer, even the U.S. government.
- c. Financial markets consider LIBOR rates as inherently liquid, stable and a reliable indicator of interest rates and, if the rate for hedging interest rate risk was limited to UST, many common hedging relationships using LIBOR-based swaps might not qualify for hedge accounting.

6. Because the Board decided to permit a rate that is not fully risk-free to be the designated risk in a hedge of interest rate risk, it developed the general notion of a benchmark interest rate to encompass both risk-free rates (UST) and rates based on the LIBOR swap curve in the U.S. During its deliberations on Statement 138, the Board considered whether other rates in the U.S. financial markets, such as the commercial paper rate and the Fed Funds rate, should be included in the definition of benchmark interest rate and whether those rates should be permitted to be designated as the hedged risk in a hedge of interest rate risk. The Board rejected the commercial paper rate and the Fed Funds rate as benchmark rates in the U.S. and decided that allowing more than two benchmark rates (that is, UST and LIBOR) to define interest rate risk was unnecessary and would make the resulting financial statements more difficult to understand. Therefore, the Board decided that other such indexes may not be used as the benchmark interest rate in the U.S.<sup>2</sup>

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<sup>2</sup> The Board did not prescriptively designate benchmark interest rates that may be used in markets outside of the U.S.

7. However, as a result of the financial crisis in 2008, reporting entities' exposure to the Fed Funds rate and/or their demand for hedging products incorporating that underlying have increased. In the U.S., the Fed Funds rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve with each other, usually overnight. Institutions with surplus balances in their accounts lend those balances to institutions in need of larger balances.<sup>3</sup> The interest rate that the borrowing bank pays to the lending bank to borrow the funds is negotiated between the two banks, and the weighted average of this rate across all such transactions on any given day is the daily Fed Funds Effective Rate (FFE).<sup>4</sup> The related OIS rate ("Overnight Index Swap" or "Fed Funds Effective Swap Rate") is the fixed rate swapped in exchange for a floating overnight rate, which is the Fed Funds Effective Rate.<sup>5</sup> For simplicity purposes, the terms "Fed Funds" or "Fed Funds Rate" in this issue encompass both the Fed Funds Effective Rate and the Fed Funds Effective Swap Rate (OIS). As mentioned above, the Fed Funds Rate has gathered increased importance and prominence as a result of the financial crisis of 2008 and its effect in the valuation of certain derivatives and hedge accounting is described below.

8. The concept of a discount rate is a key input in the valuation of derivatives. Before 2008, derivatives counterparties generally used LIBOR and LIBOR swap rates as the discount rate. This was partly based on the assumption that LIBOR historically represented the cost of financing of derivative counterparties. However, during the credit crisis of 2008, financial institutions became increasingly hesitant to lend to each other because of the concerns about the possibility of default. In a bid to address the credit concerns as well as legislative requirements to transact trades through clearing houses and regulatory proposals that may lead to increased

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<sup>3</sup> Fed Funds – Fedpoints, Federal Reserve Bank of New York (<http://www.newyorkfed.org/aboutthefed/fedpoint/fed15.html>).

<sup>4</sup> Fed Funds Effective Rate is the weighted average of the rates of all Fed Funds transactions in a particular day. Thus, the rate observed for, say, Monday transactions becomes the Fed Funds Effective Rate for Tuesday. The Fed Funds Effective Rate differs from the Fed Funds target rate in that the former is a volume-weighted daily average of actual lending/borrowing transactions between member institutions while the latter is a target rate determined by a meeting of the members of the Federal Open Market Committee.

<sup>5</sup> The OIS fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equates to the present value of the floating Fed Funds Effective Rate cash flows. Thus, in the U.S., the relationship between Fed Funds Effective Rate and OIS is the same as the relationship between LIBOR and the LIBOR swap rate (as defined in Topic 815).

margin requirements, the volume of collateralized and partially-collateralized derivatives has grown. As the volume of collateralized derivatives grew, so did the question of whether the return on the collateral that is factored into the determination of the discount rate for the valuation of derivatives should continue to be based on LIBOR.

9. Previously, the return on collateral was generally based on three-month LIBOR; however, in the past few years, the U.S. market has moved to an overnight rate, which is generally based on the Fed Funds rate, in recognition of the fact that collateral on derivatives is recomputed daily and thus available only overnight. Many clearing houses (including LCH Clearnet, the single largest clearinghouse for interest rate swaps) now use the OIS rate, instead of LIBOR, to compute margin requirements. As a result, market practice has evolved such that many derivative counterparties believe that the appropriate discount rate to use in the valuation of collateralized derivatives, which typically earn an overnight interest rate, should be based on the Fed Funds rate as that reflects the lower cost of financing of a collateralized instrument. Those derivative counterparties no longer believe LIBOR to be appropriate for discounting purposes as it may not appropriately factor in the fact that the derivatives are increasingly being collateralized. This has caused derivative counterparties to be more exposed to overnight rates even on derivatives whose cash flows are based on LIBOR resets. Therefore, the fair value of collateralized derivatives is now measured by discounting the instruments' cash flows, including LIBOR-based cash flows, at the OIS rate.

10. Also as a result of the financial crisis of 2008, interest rate risk managers have started looking for a shorter term rate with reset dates that occur on an overnight basis that is less sensitive to LIBOR swaps spread volatility. Prior to the financial crisis, LIBOR and OIS moved consistently with spreads between these rates typically about 5 to 10 basis points. However, during the volatile markets of the financial crisis (and ever since that time), spreads between those rates widened exceeding 350 basis points (LIBOR above OIS) at one point. Since UST is not set overnight, the market has grown for derivative products based on Fed Funds, which is a liquid, transparent and almost riskless rate for overnight transactions.<sup>6</sup> Banks, funds, and a

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<sup>6</sup> That is not to say that LIBOR has retreated from being the most widely used and liquid benchmark for rates for tenors of one month or more, nor has it been significantly challenged as the primary benchmark in most floating rate

growing number of corporations are currently using Fed Funds-based derivative instruments to better manage their interest rate gaps. The liquidity in Fed Funds-based derivatives has increased exponentially since the FASB made its decision not to include the Fed Funds Rate as a benchmark interest rate more than a decade ago with most of the increase occurring in the last few years. Fed Funds-based derivatives, such as Fed Funds Rate/LIBOR basis swaps, are traded in significant volumes and tenors have increased in the past several years from relative short tenors (2-3 years) up to 30 years.<sup>7</sup>

11. The exposure of risk to the Fed Funds Rate is not only limited to financial institutions and funds. Corporations are exposed to the Fed Funds Rate in the valuation of collateralized derivatives as well as the return on the collateral. Those entities see the possibility of this risk becoming even more widespread with the increased use of collateralized derivatives. Thus, corporate risk managers are concerned about managing the risk to the overnight rate (Fed Funds Rate) and utilizing that shorter-term reset rate to better manage other exposures; for example, exposure to changes in fixed rates on their debt. They are also generally concerned about attaining hedge accounting in order to more accurately portray their risk management activities. Therefore, some believe that the Fed Funds Rate also should be specified as a benchmark interest rate, in addition to UST and LIBOR.

12. A concern with not permitting the Fed Funds Rate to be a benchmark is the effect on fair value interest rate hedging. Fair value interest rate hedging is almost exclusively LIBOR-based in the U.S. because LIBOR has been designated as an appropriate benchmark for interest rate hedge accounting. Entities that use LIBOR-based fixed-to-floating swaps, which is prevalent today, as the hedging instrument in a fair value hedge of LIBOR-based interest rate risk, will experience additional ineffectiveness in the hedging relationship if Fed Funds discounting is applied to calculate the fair value of that hedging instrument. That is because, unlike the hedging instrument, paragraph 815-25-35-1 requires the carrying amount of the hedged item in a fair value hedge to be adjusted for its fair value changes *attributable to the hedged risk* and the hedged risk has to be a benchmark interest rate (LIBOR) and cannot be the Fed Funds Rate.

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loans or notes. As such, LIBOR continues to be one of the critical benchmark interest rates necessary for interest rate hedging.

<sup>7</sup> A basis swap is an interest rate swap that involves the exchange of two floating rate payments.

13. Therefore, unlike a hedging instrument, the method used to estimate the changes in value of the hedged item (for example, a bond) attributable to changes in the LIBOR benchmark interest rate (that is, risk being hedged) necessarily will utilize a discount rate that fluctuates from period to period based on changes in LIBOR as that is the hedged risk.<sup>8</sup> The effectiveness of a hedging relationship is determined by comparing the change in the fair value of the hedging instrument with the change in the value of the hedged item that is attributable to the risk being hedged. The use of different discount rates, that is use of the Fed Funds rate to value the derivative (the hedging instrument) versus a method that incorporates LIBOR rate to measure the hedged item, and different adjustments to those discount rates each period, creates additional accounting ineffectiveness in the fair value hedging relationship. In some cases, that ineffectiveness may be so significant that the hedging relationship would not meet the "highly effective" criteria to qualify for hedge accounting at inception or would not continue to qualify at certain reporting dates.<sup>9</sup>

14. In addition, another concern of not permitting the Fed Funds Rate to be a benchmark interest rate is the effect on a limited number of cash flow hedging situations. For cash flow hedges of variable interest payments on a group (portfolio) of loans that change during the term of the hedge for various reasons (such as prepayments, loan sales, and defaults), variability in cash flows could exist from changes in the credit quality of the replacement loans. This change in credit quality could cause ineffectiveness that in some situations may be so significant that the hedging relationship would not meet the "highly effective" criteria to qualify for hedge accounting at inception or would not continue to qualify at certain reporting dates.

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<sup>8</sup> Although Topic 815 does not prescribe any specific method for an entity to calculate changes in fair value attributable to the benchmark interest rate, two methodologies that may be used by an entity to estimate the changes in value attributable to the interest rate risk being hedged are illustrated in paragraphs 815-25-55-55 and 815-25-55-72 through 55-77.

<sup>9</sup> In contrast to a "long haul" method for assessing effectiveness as described above, the "shortcut" method is based on an assumption of no ineffectiveness. Accordingly, no ineffectiveness will result for hedges that qualify for the shortcut method, since the hedged item is simply adjusted for the change in value of the interest rate swap each period (that is, no separate calculation related to the hedged item is performed). However, there are stringent requirements to qualify and the "shortcut" method can only be applied to hedges of benchmark interest rates.

15. Based on the discussions above, some believe that the definition of a benchmark interest rate and its use in Topic 815 should be expanded to include the Fed Funds Rate since the current limitation of the benchmark interest rate to either UST or LIBOR may not allow entities to achieve desired hedge accounting for interest rate risk products that have reset dates of less than one month because the products used do not include a recognized benchmark interest rate hedge. Further, some believe that necessarily utilizing a discount rate that fluctuates from period to period based on changes in LIBOR (a benchmark interest rate) to measure the hedged item when the hedging instrument is discounted using a discount rate that fluctuates from period to period based on changes in the OIS rate result in inappropriate ineffectiveness in a fair value hedge of interest rate risk given the company's risk management objective.

### **Accounting Issue and Alternatives**

#### **Whether the Fed Funds Rate should be included as a U.S. benchmark interest rate for hedge accounting purposes.**

*View A: Yes. Because Topic 815 is prescriptive as to which indexes may be used as the benchmark interest rate in the U.S., an additional benchmark interest rate should be prescribed that can be designated for overnight resets. Currently, the most liquid and transparent overnight rate is the Fed Funds Rate, whereas there is little to no liquidity in overnight UST or LIBOR rates. Including the Fed Funds Rate as an acceptable U.S. benchmark interest rate in combination with UST and LIBOR will provide risk managers with a full spectrum of interest rate resets to hedge designated fair value and cash flow risks.*

16. Proponents of View A believe that the current situation in which Topic 815 prescribes only two acceptable benchmark interest rates in the U.S. is no longer tenable. Changes in the market and the growing pervasiveness of exposure to the Fed Funds Rate due to increased collateralization of derivatives and invested cash that return the Fed Funds Rate make it imperative that the hedging literature include the Fed Funds Rate as a benchmark interest rate in the U.S. so that hedging relationships based on that rate can most appropriately reflect interest rate risk hedging strategies.

17. Proponents of View A also state that Topic 815 should not be prescriptive as to the appropriate benchmark interest rate in the U.S. and that the guidance be consistent for selection of benchmarks internationally and domestically. However, given the emerging nature of the issue, proponents of View A believe that the Task Force should consider including an overnight benchmark interest rate for interest rate hedging; leaving the broader question of whether it is appropriate for the Board to prescribe benchmark interest rates to the FASB Hedge Accounting Project.

18. Proponents of View A state that the Fed Funds Rate is the most liquid and transparent overnight rate in the United States. It is available daily and is the weighted average of Fed Funds transactions between depository institutions. While it is not a "risk-free" rate like UST, it is a rate negotiated between depository institutions on excess funds at the Federal Reserve Banks, placing it in the spectrum of risk between UST and LIBOR. They believe that when the Board decided to focus on UST and LIBOR as the only acceptable benchmark interest rates in Statement 138, the predominance of Fed Funds transactions was not as great as it is today and UST and LIBOR covered a significant portion of interest rate risks. However, as a result of the financial crisis in 2008 (when financial institutions would only deal with one another on a collateralized basis) and the legislation that requires greater clearing of derivatives through exchanges or clearinghouses (which must be collateralized), use of the Fed Funds Rate with respect to collateral and short term transactions has become ubiquitous and the current hedge products based on longer term UST and LIBOR rates are not efficient or effective to hedge overnight rates.

19. Proponents of View A also believe that the FASB meant to incorporate some flexibility to add or subtract benchmark interest rates if circumstances change. In the Background Information and Basis for Conclusions to Statement 138, it is stated that

The Board determined that any definition of the benchmark interest rate that may be hedged should be flexible enough to withstand potential future developments in financial markets. For example, the Board decided that the current definition would result in the ability to replace the LIBOR swap rate with a more relevant benchmark interest rate should changes in the financial markets render the use of LIBOR swap rates obsolete.

20. While Proponents of View A do not believe that it would be appropriate to replace either UST or LIBOR (for example, LIBOR resets of one-month or greater still are necessary given current exposures), proponents believe that the lack of development of either overnight UST or overnight LIBOR rates makes it imperative that the definition of U.S. benchmark interest rates also include the Fed Funds Rate.

21. With respect to the Board's original comment in the Basis for Conclusions to Statement 138 that having more than two benchmark interest rates in the U.S. would make the financial statements more difficult to understand, proponents of View A disagree. Given the greater sophistication and understanding of derivatives and risk, and the expanded disclosures now required under Topic 815 as a result of issuance of FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, those proponents believe that providing hedge accounting for overnight interest rate risks that are appropriately designated will make the financial statements more appropriate and easier to understand as it will better reflect the risk management activities of the enterprise.

22. Proponents of View A believe that the Fed Funds Rate has become the predominant interest rate quoted in the U.S. market for collateral covering derivative exposures and allowing use of the Fed Funds Rate as an additional benchmark interest rate would more appropriately reflect interest rate risk hedging strategies.

23. In addition, for hedges of forecasted debt issuances, proponents of View A believe that the better alternative for some entities may be a forward-starting swap indexed to the Fed Funds Rate, which are viewed by some risk managers as economically superior to either Treasury locks or forward-starting LIBOR-based swaps. The economic objective of many entities that have forecasted issuances of debt is to hedge only the interest rate exposure related to their future financings. Treasury locks are designed to hedge only the interest rate exposure, but there are some key limitations and drawbacks associated with Treasury locks, in particular, a lack of liquidity for forward hedges beyond about three months and the inability to customize the terms to precisely match the underlying debt issuance (resulting in mismatched cash flows). In contrast, forward-starting LIBOR-based swaps are much more liquid than Treasury locks and

have fully customizable terms, but they introduce variability due to changes in swap spreads (that is, the credit spread between Treasuries and LIBOR). Thus, for companies that do not want to be exposed to the variability of swap spreads, oftentimes because they believe their own credit may not correlate with such changes, proponents of View A believe that forward-starting LIBOR-based swaps may not be the best economic alternative. In those situations, a swap indexed to the Fed Funds Rate is considered by proponents of View A to be the better hedging instrument from an economic standpoint.

*View B: No. Topic 815 limits the benchmark interest rate available in the U.S. market to two rates, the UST rate and LIBOR swap rate. As noted in paragraph 815-20-25-6A, the Board previously discussed whether the Fed Funds Rate should be considered a benchmark interest rate and determined that it shall be excluded from the definition.*

24. Proponents of View B note that the benchmark interest rate is defined in Topic 815 to be a rate that is widely recognized, quoted in an active market, and indicative of the overall level of interest rates attributable to high-credit-quality obligors in the market. While they agree that the Fed Funds Rate is referenced for loans of excess reserve balances at Federal Reserve Banks between depository institutions and that it is also a referenced interest rate for cash collateral receivables or payables related to derivative transactions, proponents of View B do not believe that it is necessarily a widely recognized rate for broader corporate lending transactions in the financial markets within the U.S.

25. Proponents of View B note that the Board decided the interest rate on direct Treasury obligations would provide the best measure of a risk-free rate, and only provided an exception for LIBOR mainly because of its prevalence in the market as a hedging instrument for interest rate risk. Proponents of View B believe that while the Fed Funds Rate may have become more liquid in the market, its use as a hedging instrument for interest rate risk is not as prevalent as LIBOR to be offered its own exception.

26. Proponents of View B also note that paragraph 815-20-25-6A specifically prohibits the Fed Funds Rate to be a benchmark interest rate and that the Board, during its deliberations on

Statement 138, determined that allowing more than two benchmark rates (that is, UST and LIBOR) to define interest rate risk was unnecessary and would make the resulting financial statements more difficult to understand. Proponents of View B share the same concerns in support of not allowing the Fed Funds Rate to be a benchmark interest rate.

27. The Board will be redeliberating further refinements to the hedging model within the Accounting for Financial Instruments Project. View B proponents recommend that the Board include in those redeliberations a discussion about redefining the benchmark interest rate. That will allow the Board to reconsider a more principles-based approach, granting further time to address other eligible rates, and achieving further convergence with IFRS. View B proponents believe that the ability to hedge a benchmark interest rate is a significant matter of concern and the scope of such amendments should not be narrowly discussed within the confines of the EITF.

**Agenda Decision:** *This Issue was added to the EITF agenda. The Issue would address a narrow scope emerging issue within the scope of the current hedge accounting model in Topic 815.*

**FASB EMERGING ISSUES TASK FORCE**  
**Proposed January 17, 2013 Meeting Agenda**

| <u>Issue Number</u> | <u>Issue</u>   | <u>Proposed Time</u> | <u>Staff Assigned</u>         |
|---------------------|--|----------------------|-------------------------------|
|                     | Administrative Matters   | 8:30-8:45            | Gupta                         |
| 11-A                | Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity | 8:45-9:45            | Harris/<br>Kane/<br>Alexander |
|                     | *** BREAK ***  | 9:45-10:00           |                               |
| 13-A                | Inclusion of the Fed Funds Rate as a Benchmark Interest Rate for Hedge Accounting Purposes   | 10:00-11:00          | Goswami/<br>Kane              |
| 12-D                | Accounting for Obligations Resulting from Joint and Several Liability Arrangements for which the Total Amount of the Obligation Is Fixed at the Reporting Date                               | 11:00-12:00          | Walsh/<br>Gupta               |
|                     | *** LUNCH ***  | 12:00-1:00           |                               |
| 12-B                | Not-for-Profit Entities: Personnel Services Received from an Affiliate for Which the Affiliate Does Not Seek Compensation  | 1:00-2:00            | Goswami/<br>Maroney           |
| 12-H                | Accounting for Service Concession Arrangements   | 2:00-3:00            | Gagnon/<br>Mottley            |
|                     | *** BREAK ***  | 3:00-3:15            |                               |
| 12-F                | Recognition of New Accounting Basis (Pushdown) in Certain Circumstances  | 3:15-4:45            | Gupta/<br>Or                  |

### Status of Open Issues and Agenda Committee Items

The following represents the FASB staff's assessment of the status and immediate plans with respect to the open Issues on the Task Force's agenda. The Issues that will be added to the proposed agenda for the January 17, 2013 meeting will be considered either high priority issues or issues on which meaningful progress can be made within the staff's given complement of resources. The staff's prioritization of issues is based primarily on the FASB staff's understanding of the level of diversity in practice created by each respective Issue, the financial reporting implications of that diversity, the current interaction, if any, of the Issues with active Board projects, and current resource availability among the staff (with respect to both time and relevant technical expertise).

| Issue No. | Description  | Date Added | Date(s) Discussed       | Next Meeting | EITF Liaison | FASB Staff                    | Immediate Plans   | Due Date - Next Deliverable                                       |
|-----------|--|------------|-------------------------|--------------|--------------|-------------------------------|---|---|
| 11-A      | Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity | 7/11       | 11/11, 3/12, 6/12, 9/12 | 1/13         | Bielstein    | Harris/<br>Kane/<br>Alexander | The FASB staff will prepare an Issue Supplement addressing comments received on the proposed Update | Comment deadline December 10, 2012; January 17, 2013 EITF meeting |
| 12-B      | Not-for-Profit Entities: Personnel Services Received from an Affiliate for Which the Affiliate Does Not Seek Compensation  | 2/12       | 3/12, 6/12              | 1/13         | Althoff      | Goswami/<br>Maroney           | The FASB staff will prepare an Issue Supplement addressing comments received on the proposed Update | January 17, 2013 EITF meeting                                     |

| <b>Issue No.</b> | <b>Description</b>   | <b>Date Added</b> | <b>Date(s) Discussed</b> | <b>Next Meeting</b> | <b>EITF Liaison</b> | <b>FASB Staff</b>  | <b>Immediate Plans</b>  | <b>Due Date - Next Deliverable</b>                              |
|------------------|--|-------------------|--------------------------|---------------------|---------------------|--------------------|---|---|
| 12-D             | Accounting for Obligations Resulting from Joint and Several Liability Arrangements for which the Total Amount of the Obligation Is Fixed at the Reporting Date | 2/12              | 3/12, 6/12               | 1/13                | Uhl                 | Walsh/<br>Gupta    | The FASB staff will prepare an Issue Supplement addressing comments received on the proposed Update | January 17, 2013 EITF meeting                                   |
| 12-F             | Recognition of New Accounting Basis (Pushdown) in Certain Circumstances  | 5/12              | N/A                      | 1/13                | Evans               | Gupta/<br>Or       | The FASB staff will prepare an Issue Summary that includes a Working Group Report                   | January 17, 2013 EITF meeting                                   |
| 12-G             | Accounting for the Difference between the Fair Value of the Assets and the Fair Value of the Liabilities of a Consolidated Collateralized Financing Entity     | 7/12              | 9/12                     | 1/13                | Day                 | Brown/<br>McKinney | The FASB staff will prepare an Issue Supplement addressing comments received on the proposed Update | Comment deadline December 10, 2012; March 14, 2013 EITF meeting |
| 12-H             | Accounting for Service Concession Arrangements   | 9/12              | N/A                      | 1/13                | Althoff             | Gagnon/<br>Mottley | The FASB staff will prepare an Issue Summary  | January 17, 2013 EITF meeting                                   |

| <b>Issue No.</b> | <b>Description</b>  | <b>Date Added</b> | <b>Date(s) Discussed</b> | <b>Next Meeting</b> | <b>EITF Liaison</b> | <b>FASB Staff</b> | <b>Immediate Plans</b>                       | <b>Due Date - Next Deliverable</b> |
|------------------|---|-------------------|--------------------------|---------------------|---------------------|-------------------|--|------------------------------------|
| 13-A             | Inclusion of the Fed Funds Rate as a Benchmark Interest Rate for Hedge Accounting Purposes                              | 11/12             | N/A                      | 1/13                | TBD                 | Goswami/<br>Kane  | The FASB staff will prepare an Issue Summary | January 17, 2013 EITF meeting      |
| 13-B             | Accounting for Investments in Tax Credits   | 11/12             | N/A                      | TBD                 | TBD                 | Or/<br>Klumpp     | The FASB staff will prepare an Issue Summary | Future EITF meeting                |
| 13-C             | Presentation of a Liability for an Unrecognized Tax Benefit When a Net Operating Loss or Tax Credit Carryforward Exists | 11/12             | N/A                      | TBD                 | TBD                 | Walsh/<br>Irwin   | The FASB staff will prepare an Issue Summary | Future EITF meeting                |

| <b>Other EITF Issues including Inactive Issues Pending Developments in Board Projects</b> |  |                   |                          |                     |                   |  |   |
|---|--|-------------------|--------------------------|---------------------|-------------------|--|---|
| <b>Issue No.</b>  | <b>Description</b>   | <b>Date Added</b> | <b>Date(s) Discussed</b> | <b>Next Meeting</b> | <b>FASB Staff</b> | <b>Immediate Plans</b>   | <b>Due Date - Next Deliverable</b>      |
| 03-15   | Interpretation of Constraining Conditions of a Transferee in a Collateralized Bond Obligation Structure  | 11/02             | N/A                      | Not scheduled       | TBD               | Statement 166 addressed this Issue and, therefore, the FASB staff will request that the Issue be removed from the EITF's technical agenda at a future meeting. | Future Agenda Committee or EITF Meeting |
| 06-12   | Accounting for Physical Commodity Inventories for Entities within the Scope of the AICPA Audit and Accounting Guide, Brokers and Dealers in Securities | 8/06              | 11/06                    | Not scheduled       | TBD               | No immediate plans to address this Issue.  | Future EITF Meeting                     |
| 09-D  | Application of the AICPA Audit and Accounting Guide, Investment Companies, by Real Estate Investment Companies   | 2/09              | N/A                      | Not scheduled       | TBD               | Pending the outcome of the Board's projects on consolidation, investment companies, and investment properties.   | Future EITF Meeting                     |
| 10-B  | Accounting for Multiple Foreign Exchange Rates   | 3/10              | 7/10, 9/10               | Not scheduled       | TBD               | No immediate plans to address this Issue.  | N/A                                     |

| <b>Issues Pending Further Consideration by the Agenda Committee</b> |  |                   |                          |                     |                   |  |                                    |
|---|--|-------------------|--------------------------|---------------------|-------------------|--|------------------------------------|
| <b>Issue No.</b>  | <b>Description</b>   | <b>Date Added</b> | <b>Date(s) Discussed</b> | <b>Next Meeting</b> | <b>FASB Staff</b> | <b>Immediate Plans</b>   | <b>Due Date - Next Deliverable</b> |
| N/A   | Application of EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," When a Special-Purpose Entity Holds Equity Securities and Whether an Investment That Is Redeemable at the Option of the Investor Should Be Considered an Equity Security or Debt Security | 9/00              | N/A                      | Not scheduled       | TBD               | Statement 155 did not address this Issue. Therefore, the FASB staff will bring this Issue to the Agenda Committee at a future meeting to determine whether to begin discussions on this Issue. | Future Agenda Committee meeting    |