

**Board Meeting Handout**  
**Discussion of Private Company Council (PCC) Issues**  
**January 22, 2014**

In preparation for the January 28, 2014 PCC meeting, the Board will discuss the following four papers:

1. PCC Issue No. 13-01A, "Accounting for Identifiable Intangible Assets in a Business Combination," Outreach Update
2. PCC Issue No. 13-01A, "Accounting for Identifiable Intangible Assets in a Business Combination," Issue Summary No. 1, Supplement No. 3
3. PCC Issue No. 13-02, "Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements," Issue Summary No. 1, Supplement No. 2
4. PCC Issue No. 13-03B, Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Combined Instruments Approach," Issue Summary No. 1, Supplement No. 2.

**1. PCC Issue No. 13-01A, "Accounting for Identifiable Intangible Assets in a Business Combination," Outreach Update**

**PURPOSE OF THIS MEETING**

1. The purpose of this meeting is to provide the Board with a summary of the previous outreach efforts and inform the Board about the additional outreach activities, including research, analysis, and stakeholder meetings, that the FASB staff conducted subsequent to the September 30-October 1, 2013 PCC meeting. The staff's additional outreach includes private companies, public business entities (PBEs), and not-for-profit entities (NFPs).

**BACKGROUND**

2. On July 1, 2013, the FASB and the Private Company Council (PCC) issued a proposed Accounting Standards Update, Business Combinations (Topic 805): *Accounting for Identifiable Intangible Assets in a Business Combination* (the proposed Update). At its October 1, 2013 meeting, the PCC was provided with (a) a summary of the outreach activities undertaken and comments received in

---

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

response to the proposed Update and (b) the staff's analysis and recommendation for the primary issues identified as a result of the feedback received. At that meeting, the PCC directed the FASB staff to conduct additional research, analysis, and outreach for discussion at the January 27-28, 2014 meeting.

### **SUMMARY OF OUTREACH ACTIVITIES AND RESEARCH PERFORMED**

3. The staff performed outreach activities and research about the applicability of various alternatives for initial recognition of intangible assets in a business combination to private companies, PBEs, and NFPs. The alternatives the staff considered, which are described below in more detail, are (a) do not recognize any intangible assets separately from goodwill, (b) only recognize intangible assets if they are capable of being sold or licensed independently from other assets of the business, and (c) no change to U.S. GAAP. Specifically, the staff:
4. Reviewed comment letter responses to the proposed Update for PCC Issue 13-01A.
5. Reviewed the basis for conclusions, comment letters, and outreach summaries for other FASB and FAF projects in relevant areas including:
  - Statement No. 141, *Business Combinations*
  - Statement No. 141 (revised 2007), *Business Combinations*
  - Statement No. 142, *Goodwill and Other Intangible Assets*
  - Statement No. 164, *Not-for-Profit Entities: Mergers and Acquisitions*
  - Post Implementation Review (PIR) of Statement 141(R).
6. Performed outreach with individual stakeholders including users of financial statements (including lenders, equity investors, and analysts), preparers, practitioners, and valuation specialists of private companies, PBEs, and NFPs.
7. Performed outreach with private company stakeholder groups including the AICPA's PCPS Technical Issues Committee and the FASB Small Business Advisory Committee.

8. Performed outreach with PBE stakeholder groups including the FASB Investors Advisory Council (IAC) and the Securities and Exchange Commission (SEC).
9. Performed outreach with NFP stakeholder groups including the FASB Not-for-Profit Advisory Committee (NAC).

## **Summary of Feedback**

### *Feedback – Private Companies*

10. Private company preparers were generally supportive of changes to intangible asset recognition if it would reduce costs for preparers. They believe that the costs of estimating the fair value of intangible assets, including the cost to hire a third-party specialist to prepare an appraisal of intangible assets, were significant, and they asserted that the information provided little benefit to users of private company financial statements.
11. Most private company preparers did not think convergence with IFRS on this topic should be a significant consideration for private companies. IFRS already has different business combination guidance for Small and Medium-sized Entities.
12. Users of private company financial statements had mixed views on the usefulness of information on the fair value of intangible assets. Some users, including lenders and equity investors, indicated that they generally disregard intangible assets and the associated amortization and treat them no differently than goodwill. Other users indicated that they do consider the identification, value, and subsequent impairments of intangibles to be decision-useful information in some instances. Those users have similar views when describing the attributes of intangible assets they find most relevant (legally protected, separately transferable, and with discrete cash flows), but did not come to an agreement on which specific intangible assets are most relevant.
13. Some users, including lenders and equity investors, indicated that they support an alternative that would permit all intangible assets to be subsumed into goodwill in order to reduce costs to preparers. However, those users indicated that they

generally have significant access to management. Accordingly, if private companies no longer recognized some or all intangible assets, the users would be able to obtain information regarding those unrecognized intangible assets directly from management if they were of interest to the user. Some of those users indicated that even with the separate recognition of intangible assets under current U.S. GAAP, they perform their own valuation of certain intangible assets in certain circumstances (for example, a bank that lends against technology intellectual property).

14. Additional detail on the feedback received from private company stakeholders is included in Issue Summary No 1, Supplement No. 1, used to facilitate the discussion at the October 1, 2013 PCC meeting.

*Feedback from PBEs*

15. Overall, the staff's outreach and research indicated that most PBE stakeholders (including users, practitioners, and preparers) generally do not believe that there should be a difference in the accounting for intangible assets between private companies and PBEs. Despite not believing that there should be a difference between private companies and PBEs, many stakeholders thought that if changes are made to accounting for private companies, those changes should not be extended to apply to PBEs. Most stakeholders indicated that they do not see a significant need for, or do not want, a change to current U.S. GAAP for the accounting for intangible assets in a business combination. Specific feedback, including user feedback, is discussed in the following paragraphs.

**Comment letters on PCC Issue 13-01A**

16. The proposed Update asked respondents the following question:

Should the Board consider expanding the scope of the accounting alternative to other entities, such as publicly traded companies or NFPs? If the scope is expanded to other entities, what changes, if any, should the Board consider to the accounting alternative for the identification of intangible assets/subsequent measurement of goodwill? If the scope is expanded to public companies or not-for-profit entities, should the accounting alternative continue to be elective?

17. The feedback from the comment letters (including both PBE and private company stakeholders) was mixed in regards to whether the proposed alternative for identifiable intangible assets in a business combination should be expanded to PBEs. Supporters of the extension were comprised mainly of CPA state associations and smaller practitioners. Many of those respondents, however, did not provide a robust perspective of their views. They indicated that many of the issues faced by private companies also are experienced by PBEs and, accordingly, the proposed alternative should be made available to both types of entities. Some of those respondents recommended that the Board perform additional outreach activities with the users of PBE financial statements to ensure that the information provided under the proposed alternative would still be considered relevant and decision-useful to users.
18. Respondents who indicated that they do not believe that the proposed alternative should be extended to PBEs primarily included larger accounting firms, professional associations, and a smaller number of state CPA associations. Respondents highlighted the following reasons for their opinion:
  - a. Most users of PBE financial statements generally do not have access to management and, accordingly, they would not be able to obtain information regarding unrecognized intangible assets beyond the proposed qualitative disclosures.
  - b. The extension of the proposal to PBEs would generate significant divergence from IFRS and impair the convergence effort undertaken by the FASB and the IASB.
  - c. Costs incurred by PBEs in measuring intangible assets typically are not significant.
  - d. Respondents indicated that a more comprehensive reconsideration of the existing accounting model (beyond the proposed Update) for the recognition and measurement of intangible assets in a business combination should be performed for all entities.

**Research**

*Statement 141, Statement 141R, and PIR findings on Statement 141R*

19. The staff performed research to obtain information about stakeholder views about recognition of intangible assets and discussions by the Board and staff that took place during deliberations that lead to Statement 141 and Statement 141R. The research included examining the basis for conclusions of those standards, reviewing comment letters to the proposals, and reviewing other related documents in the project files. The staff also reviewed the findings from the PIR on Statement 141R and the FASB's subsequent analysis of the PIR findings.

20. Paragraph B171 of Statement 141R states the following:

...some respondents doubted their ability to reliably measure the fair values of many intangible assets. They suggested that the only intangible assets that should be recognized separately from goodwill are those that have direct cash flows and those that are bought and sold in observable exchange transactions. The FASB rejected that suggestion. Although the fair value measures of some identifiable intangibles might lack the precision of the measures for other assets, the FASB concluded that the information that will be provided by recognizing intangible assets at their estimated fair values is a more faithful representation than those that would be provided if those intangible assets were subsumed into goodwill. Moreover, including finite-lived intangible assets in goodwill that is not being amortized would further diminish the faithfulness of financial statements.

21. The PIR report on Statement 141R indicated that both private companies and PBEs, particularly smaller PBEs, struggled with the measurement of intangible assets at fair value because this measurement can be complex. As a result, costs are being incurred to hire external valuation specialists to estimate the fair value of intangibles and auditors to test those values. Per the PIR report, users of both public and private companies found the identification of separate intangibles useful, but noted that inconsistent application of FASB Statement No. 157, *Fair Value Measurements*, to the measurement of such intangibles resulted in a lack of comparability and reliability.<sup>1</sup>

---

<sup>1</sup> The FAF is in the process of completing a PIR of Statement 157. The FASB staff understands that the FAF received similar feedback about the lack of comparability in that PIR. However, the FASB staff does not yet understand specifically what the lack of comparability is about and whether there is a specific issue in Statement 157 that is causing the lack of comparability or whether stakeholders are observing that fair

## Users

22. Most PBE users preferred current GAAP to any of the proposed alternatives. However, similar to users of private company and NFP financial statements, users of PBE financial statements had mixed views on the usefulness of information on the fair value of intangible assets. Responses on the importance and usefulness of fair value information of particular intangible assets also varied significantly depending on the industry considered.
23. Many users, primarily equity investors and analysts, indicated their concerns about any potential changes to simplify the accounting for intangible assets in a business combination. Those users highlighted that many companies in the current economy are driven by the creation and use of intangible assets (for example, intellectual property). Those users stated that they find intangible assets provide decision-useful information. They are interested in the types of the intangible assets and value of intangible assets (that is, what the acquirer paid for). Those users indicated that goodwill should be shown separately from other intangible assets and have distinct characteristics. For example, intangibles including trademarks, patents, and brands can be considered more valuable than goodwill.
24. Many of those users highlighted that one issue is that certain intangible assets are inherently difficult to value. However, they indicated that both fair value and historical cost provide relevant information to users and they would find it helpful to understand more detail about how management values intangible assets in acquisitions. Other users, including investors and analysts however, indicated that the value of some intangible assets does not provide decision-useful information for a variety of reasons, including subjectivity/reliability of the valuations and relevance to particular industries.
25. Most users of PBE financial statements indicated that unlike users of private company financial statements, they do not generally have access to management.

---

value estimates require significant use of judgment and that different professionals can reach different conclusions.

Accordingly, they would not be able to obtain information regarding unrecognized intangible assets beyond any information disclosed in footnotes.

#### IAC

26. Overall, the feedback received from IAC members (consisting primarily of analysts who follow financial institutions) was mixed. IAC members had differing views about whether a proposed alternative should be extended to PBEs.
27. IAC members stated that some intangible assets can be relevant depending on the industry and that the performance of an impairment analysis and the potential recording of an impairment charge are perceived as indicators of management accountability.
28. IAC members who were open to extending a proposed alternative to PBEs noted that users of PBE financial statements generally place limited reliance on the value of intangible assets separately from goodwill in the financial statements and that some intangible assets (such as customer relationships) can be difficult to separately value and are, therefore, often ignored by many analysts. Thus, the IAC members reasoned that reducing the number of recognized intangible assets would not deprive financial statements users of significant information. Those users also indicated that intangible assets typically represent a minor component of an acquisition, while goodwill generally results in a significant portion. The staff observes, however, that this is not always the case; in some acquisitions, intangibles are significant.

#### Preparers

29. The staff performed outreach with preparers of PBEs from various industries, including financial services, technology, health care, and defense. The staff's intent was to reach out to preparers from a variety of industries who had experience with conducting business combinations and accounting for intangibles under current U.S. GAAP. Most PBE preparers indicated that they did not consider the cost of determining the fair value of intangible assets acquired in a business combination to be significant in the context of a business combination.

30. PBE preparers stated that users rarely ask specific questions regarding the intangible assets recorded on their financial statements and that questions are generally related to impairment of assets. Some preparers also stated that they are interested in the existence of intangible assets owned by a target (for example, intellectual property) and management considers the intangible assets in estimating cash flows of the target.

**Convergence with IFRS**

31. Statement 141R was issued together with IASB's IFRS 3 and is a converged standard (with some differences). Any potential change in this area for public companies could affect convergence with IFRS. Some stakeholders highlighted that a change for PBEs could affect convergence with IFRS, making comparisons between PBEs in the U.S. and internationally more difficult. Those stakeholders noted that any cost reduction associated with the preparation of financial statements should be weighed against the cost increase associated with a lack of comparability (for example, analysts might attempt to make adjustments to the balance sheets of U.S. GAAP preparers in a particular industry in order to compare them to IFRS preparers in the same industry).

*Feedback – NFP Entities*

32. The staff notes that many NFPs do not recognize significant intangibles. For many NFPs, their business combination activity is often considered a merger and no intangibles are recorded. However, for those NFPs that do engage in business combinations, respondents generally believe that the cost-benefit evaluations for intangible assets between private companies and NFPs are very similar, and, therefore, any changes to recognition of intangible assets made for private companies should also apply to NFPs.

**Comment letters on PCC Issue 13-01A**

33. Nearly all respondents who provided feedback demonstrated support for the expansion of the scope of the proposed accounting alternative to NFPs and indicated that NFPs typically face many of the same issues experienced by private companies and that user needs can be similar.

### Outreach on previous projects

34. In the preliminary outreach performed for the October 2006 Exposure Draft, *Not-for-Profit Organizations: Mergers and Acquisition*, which ultimately led to the issuance of Statement 164, most respondents agreed with the overall approach of requiring the same accounting treatment for acquisitions by and among for-profit entities, except in specific instances in which significantly different circumstances warrant different accounting.
35. However, many of the respondents to the October 2006 Exposure Draft raised concerns over the recognition and measurement of donor relationships, because donors are more analogous to investors than customers. As a result, the Board made a specific recognition exception for donor relationships in Statement 164 and donor-related relationships are not considered to be a separately recognized intangible under today's guidance for NFPs.

### NAC and other users

36. NAC members asserted that their financial statement users generally do not find information on many intangible assets to be decision useful and that some intangible assets can be difficult to value.
37. Lenders of NFPs provided feedback that was similar to the feedback received from users of private companies and PBEs and indicated that some intangibles are more relevant than others and that relevance often depends on the type of organization. Some lenders view intangible assets differently than goodwill because some intangible assets can provide relevant information depending on the industry. Those users indicated that unlike the assessment of goodwill impairment, which is a recurring annual cost, the identification of intangible assets is a one-time cost.

### **ALTERNATIVES**

38. The staff has identified three alternatives for the Board's consideration for private companies, PBEs, and NFPs:
  - a. **Alternative A – No Intangibles Approach:** An entity would not recognize any intangible assets separately from goodwill.

- b. **Alternative B – No Intangibles except Those Capable of Being Sold or Licensed Independently from Other Assets of the Business:** All intangibles would be subsumed into Goodwill and Other Intangible Assets except those that are capable of generating cash flows separate and distinct from a business.
- c. **Alternative C – No change to U.S. GAAP:** Continue to require recognizing and measuring identifiable intangible assets acquired in a business combination in accordance with Topic 805.

## Board Meeting Handout

### 2. PCC Issue No. 13-01A, "Accounting for Identifiable Intangible Assets in a Business Combination," Issue Summary No. 1, Supplement No. 3

January 22, 2014

**PCC Issue No.** 13-01A

**Title:** Accounting for Identifiable Intangible Assets in a Business Combination

**Document:** Issue Summary No. 1, Supplement No. 3\*

**Date Prepared:** January 16, 2014

**FASB Staff:** Elizabeth Gagnon (203-956-3477) / Adam Smith (203-956-5282) /  
Laura Winkler (203-956-5279) / Emily Booth (203-956-5273)

**Dates previously discussed:** February 12, 2013; May 7, 2013; October 1, 2013;  
November 12, 2013

**Previously distributed PCC materials:** Agenda Request Issue No. 1, dated February 1, 2013; Issue Summary No. 1, dated May 26, 2013; Proposed Accounting Standards Update, dated July 1, 2013; Power Point Presentation, dated September 17, 2013; Issue Summary No. 1, Supplement No. 1, dated September 23, 2013; Issue Summary No. 1, Supplement No. 2, dated September 25, 2013; Power Point Presentation, dated November 12, 2013

### Background and Purpose

1. On July 1, 2013, the FASB and the Private Company Council (PCC) issued a proposed Accounting Standards Update, *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination* (the proposed Update). At

---

**\* The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the PCC. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the PCC makes such a determination, exposes it for public comment, and it is endorsed by the Board.**

---

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

its October 1, 2013 meeting, the PCC was provided with (a) a summary of the outreach activities undertaken and comments received in response to the proposed Update and (b) the staff's analysis and recommendation for the primary issues identified as a result of the feedback received. At that meeting, the PCC directed the FASB staff to conduct additional research, analysis, and outreach for discussion at the January 27-28, 2014 meeting.

2. On January 15, 2014, Memo No. 2 was distributed to the Board and the PCC for discussion at the January 22, 2014 Board meeting. That memorandum includes a summary of the previous and additional outreach activities, including research, analysis, and stakeholder meetings, that the FASB conducted with private companies, public business entities (PBEs), and not-for-profit entities (NFPs). That memorandum also includes the staff's recommendations on how Issue 13-01A could apply for PBEs and NFPs.

3. The purpose of this Issue Supplement is to provide the PCC with a summary of the previous outreach efforts and inform the PCC about the additional outreach activities, including research, analysis, and stakeholder meetings, that the FASB staff conducted subsequent to the September 31-October 1, 2013 PCC meeting.

4. This Issue Supplement is organized as follows:

- a. Issue 1: How intangible assets acquired in a business combination should be recognized
- b. Issue 2: Disclosure
- c. Issue 3: Transition
- d. Issue 4: Effective Date and Early Application
- e. Issue 5: Linkage with PCC Issue No. 13-01B
- f. Issue 6: Re-Exposure

## **Accounting Issues and Alternatives**

**Issue 1: How intangible assets acquired in a business combination should be recognized.**

*Summary of Outreach Activities and Research Performed*

5. The staff performed outreach and research activities to determine the applicability of various alternatives for initial recognition of intangible assets in a business combination to private companies. The alternatives the staff considered, which are described below in more detail, are (a) do not recognize any intangible assets separately from goodwill, (b) only recognize intangible assets if they are capable of being sold or licensed independently from other assets of the business, and (c) no change to U.S. GAAP. Specifically, the staff:

- a. Reviewed comment letter responses to the proposed Update for PCC Issue 13-01A.
- b. Reviewed the basis for conclusions, comment letters, and outreach summaries for other FASB and FAF projects in relevant areas including:
  - Statement No. 141, *Business Combinations*
  - Statement No. 141 (revised 2007), *Business Combinations*
  - Statement No. 142, *Goodwill and Other Intangible Assets*
  - Statement No. 164, *Not-for-Profit Entities: Mergers and Acquisitions*
  - Post Implementation Review (PIR) of Statement 141(R)
- c. Performed outreach with individual stakeholders including users of financial statements (including lenders, equity investors, and analysts), preparers, practitioners, and valuation specialists of private companies.
- d. Performed outreach with private company stakeholder groups including the AICPA's PCPS Technical Issues Committee and the FASB Small Business Advisory Committee.

*Summary of Feedback*

6. Private company preparers were generally supportive of changes to intangible asset recognition if it would reduce costs for preparers. They believe that the costs of estimating the fair value of intangible assets, including the cost to hire a third-party specialist to prepare an appraisal of intangible assets, were significant, and they asserted that the information provided little benefit to users of private company financial statements.

7. Most private company preparers did not think convergence with IFRS on this issue should be a significant consideration for private companies. IFRS already has different business combination guidance for Small and Medium-sized Entities.

8. Users of private company financial statements had mixed views on the usefulness of information on the fair value of intangible assets. Some users, including lenders and equity investors, indicated that they generally disregard intangible assets and the associated amortization and treat intangible assets no differently than goodwill. Other users indicated that they do consider the identification, value, and subsequent impairments of intangibles to be decision-useful information in some instances. Those users have similar views when describing the attributes of intangible assets they find most relevant (legally protected, separately transferable, and provide discrete cash flows), but did not come to an agreement on which specific intangible assets are most relevant.

9. Some users, including lenders and equity investors, indicated that they support an alternative that would permit all intangible assets to be subsumed into goodwill in order to reduce costs for preparers. However, those users indicated that they generally have significant access to management. Accordingly, if private companies no longer recognized some or all intangible assets, those users, if interested, would be able to obtain information regarding unrecognized intangible assets directly from management. Some of those users indicated that even with the separate recognition of intangible assets under current U.S. GAAP, they perform their own valuation of certain intangible assets in certain circumstances (for example, a bank that lends against technology intellectual property).

10. Additional detail on the feedback received from private company stakeholders is included in Issue Summary No 1, Supplement No. 1, used to facilitate the discussion at the October 1, 2013 PCC meeting.

*Research: Statement 141, Statement 141R, and PIR findings on Statement 141R*

11. The staff performed research to obtain information about stakeholder views on the recognition of intangible assets and the discussions by the Board and staff that took place during deliberations that lead to Statement 141 and Statement 141R. The research included examining the basis for conclusions of those standards, reviewing comment letters to the proposals, and reviewing other related documents in the project files. The staff also reviewed the findings from the PIR on Statement 141R and the FASB's subsequent analysis of the PIR findings.

12. Paragraph B171 of Statement 141R states the following:

...some respondents doubted their ability to reliably measure the fair values of many intangible assets. They suggested that the only intangible assets that should be recognized separately from goodwill are those that have direct cash flows and those that are bought and sold in observable exchange transactions. The FASB rejected that suggestion. Although the fair value measures of some identifiable intangibles might lack the precision of the measures for other assets, the FASB concluded that the information that will be provided by recognizing intangible assets at their estimated fair values is a more faithful representation than those that would be provided if those intangible assets were subsumed into goodwill. Moreover, including finite-lived intangible assets in goodwill that is not being amortized would further diminish the faithfulness of financial statements.

13. The PIR report on Statement 141R indicated that both private companies and PBEs, particularly smaller PBEs, struggled with the measurement of intangible assets at fair value because this measurement can be complex. As a result, costs are being incurred to hire external valuation specialists to estimate the fair value of intangibles and auditors to test those values. Per the PIR report, users of both public and private companies found

the identification of separate intangibles useful, but noted that inconsistent application of FASB Statement No. 157, *Fair Value Measurements*, to the measurement of such intangibles has resulted in a lack of comparability and reliability.<sup>1</sup>

#### *Alternatives*

14. The FASB staff has identified three alternatives for the PCC's consideration for private companies:

- a. **View A** – *No Intangibles View: An entity would not recognize any intangible assets separately from goodwill.*
- b. **View B** – *No Intangibles except Those Capable of Being Sold or Licensed Independently from Other Assets of the Business: All intangibles would be subsumed into Goodwill and Other Intangible Assets except those that are capable of generating cash flows separate and distinct from a business.*
- c. **View C** – *No change to U.S. GAAP: Continue to require recognizing and measuring identifiable intangible assets acquired in a business combination in accordance with Topic 805.*

15. Under both View A and View B, an entity would be required to disclose qualitatively the nature of identifiable intangible assets that are not recognized separately from goodwill as a result of applying the proposed alternative.

16. The staff believes that if the PCC chooses View A or View B, there are potential follow-on issues within U.S. GAAP that the PCC may want to consider; including how to account for unfavorable contracts, intangible assets acquired in asset acquisitions, the impairment test when grouping long-lived assets, and how to account for subsequent sales of unrecognized assets.

---

<sup>1</sup> The FAF is in the process of completing a PIR of Statement 157. The FASB staff understands that the FAF received similar feedback about the lack of comparability in that PIR. However, the FASB staff does not yet understand specifically what the lack of comparability is about and whether there is a specific issue in Statement 157 that is causing the lack of comparability or whether stakeholders are observing that fair value estimates require significant use of judgment and that different professionals can reach different conclusions.

### ***View A***

17. Under View A, an entity would not recognize any intangible asset in a business combination separately from goodwill. Goodwill would be re-characterized as Goodwill and Other Intangible Assets. Entities would be required to disclose the nature (not fair value) of all intangibles that are identifiable under current accounting guidance but unrecognized as a result of applying this approach.

18. If the PCC were to pursue View A, then another consideration is whether there are any types of intangible assets that would be separately recognized in a business combination (for example, favorable or unfavorable contracts/leases or intangible assets recognized on the acquiree's balance sheet prior to the acquisition, such as rights purchased to use another party's intellectual property). The PCC also would need to clarify whether software, which is an intangible asset, would be separately recognized in a business combination.

19. Proponents of View A argue that the cost of separately recognizing intangible assets outweighs the benefits. They observe that some users of financial statements disregard the fair value of recognized intangible assets and, therefore, subsuming all intangibles into goodwill would not reduce the usefulness of financial statements. Further, proponents believe that View A would significantly reduce cost and complexity because companies would no longer need assistance from outside valuation professionals for the valuation of intangible assets. View A also would eliminate the judgment element that is currently necessary in valuing intangible assets. Finally, proponents observe that when the fair value of intangibles is important, users sometimes develop their own estimate of current fair value (for example, a bank that lends against intangible assets).

20. Many proponents of View A note that users of private company financial statements could obtain information from qualitative disclosures about the nature of the acquired intangibles and, if needed, ask management to provide additional information about such intangibles (for example, cash flows, fair value, or otherwise).

21. Opponents of View A argue that separately recognizing intangible assets provides useful information in general purpose financial statements. They point out that intangible assets are increasingly important to the U.S. and the global economy, and grouping all intangibles and goodwill would reduce the overall relevance of financial statements. One might question why more detailed accounting would be required for property, plant, and equipment than intangible assets and one could argue that non-recognition of intangible assets in the current economy could be used as an example of why U.S. GAAP financial statements are not highly relevant. Opponents note that recognition of intangible assets and subsequent impairment testing provides users with indications about management's expectations for future cash flows and indications about management's business acumen (for example, does management have a history of successfully integrating acquisitions). However, those opponents acknowledge that this information is not always provided or is provided timely by the separate recognition of intangible assets.

22. Opponents also note that grouping all intangible assets into goodwill could cause acquisitions to appear more accretive to earnings than they actually are. For example, purchasing a business with completed or nearly completed technology could allow acquirers to recognize all of the future earnings from that technology without recognizing the cost of acquiring the assets generating the cash flows. If an entity elects to apply PCC Issue 13-01B to account for goodwill, that concern could be mitigated somewhat. However, a user would not know what part of the amortization expense relates to acquired technology and what part of the amortization expense relates to other assets.

23. Opponents believe that View A would lead to a misrepresentation of intangible assets because dissimilar items with different useful lives, different risks, and different cash flows would be grouped together into one line item that would not be a faithful representation of the underlying economic phenomena. Opponents also refer to FASB Concepts Statement No. 5. *Recognition and Measurement in Financial Statements of Business Enterprises*, which states that "analysis aimed at objectives such as predicting amounts, timing, and uncertainty of cash flows requires financial information segregated

into reasonably homogeneous groups." Moreover, when there is a sale of an intangible asset (or a group of assets), an entity's gain or loss calculation would not capture the carrying amount of the assets leading to overstated gains or understated losses (except when the intangible sold constitutes a business, in which case a relative portion of the goodwill would be allocated to the carrying amount of the business sold).

24. Opponents believe that including finite-lived intangible assets in goodwill that is not being amortized or being amortized over a period that differs significantly from the component intangible assets would further diminish the usefulness of subsequent financial statements.

***View B***

25. Under View B, intangible assets that are capable of being sold or licensed independently from the other assets of the business (for example, technologies and trade names) would be recognized separately from goodwill. Intangible assets incapable of being sold or licensed independently from a business' other assets would be subsumed into goodwill and other intangible assets. Examples of assets that would generally not be recognized separately from goodwill include customer related intangibles (CRI) and non-compete agreements (NCA). In certain industries, CRIs are capable of being sold independently from a business (for example, mortgage servicing rights and banking core deposits), and those particular CRIs would continue to be recognized separately from goodwill under View B. However, other CRIs, including contracts in place, are generally not able to be sold or licensed separately from the business, and would therefore no longer be recognized separately from goodwill. View B would result in recognition of intangible assets that are actually licensed or sold to third parties as well as intangible assets that are solely used internally, but which could be sold or licensed to third parties.

26. Some concerns have been raised including the potential for complexity and operational challenges of applying View B in practice. For example, some stakeholders questioned how an entity would determine what assets are capable of being sold or licensed independently from the other assets of a business. For example, contracts may

not always be explicit as to whether that contract can be sold, potentially requiring the preparer to make a legal assessment. Therefore, another alternative to implement View B would be a practical expedient to current U.S. GAAP in which the guidance would specifically state that CRIs and NCAs would not be separately recognized except for specific customer intangibles (for example, mortgage servicing rights and bank core deposits).

27. Proponents believe that View B is consistent with the way current U.S. GAAP treats assembled workforce. Current U.S. GAAP acknowledges assembled workforce as an asset, but does not permit assembled workforce to be separately recognized from goodwill because it does not meet the separable or contractual criteria for asset recognition. Assembled workforce cannot be sold or licensed to third parties and is incapable of generating cash flows that are independent from a company's other assets. Similarly, proponents of View B argue that CRIs and NCAs are typically not capable of being sold individually nor can they be licensed to third parties, making them incapable of generating cash flows independent from a business. Under View B, the value of assets that cannot be separated from a business or generate independent cash flows would be subsumed into goodwill, just as assembled workforce is under current U.S. GAAP.

28. Proponents also argue that while the value of intangibles that can be sold or licensed may be important to some users of financial statements, the value of CRIs and NCAs is disregarded by other users. A qualitative description of those assets (through additional disclosures) may be sufficient for users to understand the nature and importance of those assets. For example, financial statement users may be interested in understanding whether a non-compete agreement has been signed, what period it covers, and which parties are covered by the NCA, but the fair value assigned to the NCA under current GAAP is often not as important.

29. Proponents point out that CRIs and NCAs are among the most subjective and difficult intangible assets to value. As a result, they believe View B would result in cost savings to preparers without significantly affecting users. Proponents believe that the

value of intangible assets that are capable of being sold or licensed, such as technology and trademarks, are relevant to many users including private company financial statement users. While proponents acknowledge that this alternative may not result in as significant a reduction in cost as would View A, they believe that it would reduce unnecessary cost and complexity related to valuing intangible assets whose fair value may have little relevance to some users. View B would require most CRIs to be subsumed into goodwill, which some users believe is not decision useful because those assets generally are not transferable or separable from the entity, and because their values are subjective.

30. Proponents note that the assets that would still be recognized apart from goodwill under View B are often valued under methods other than the multi-period excess earnings method (MPEEM) (for example, under a Relief-from-Royalty or Cost-to-Recreate method). As noted in prior education sessions, the MPEEM is currently used in nearly every business combination purchase price allocation. While there may be some circumstances in which the MPEEM is still applied (requiring a valuation of all of the company's assets), proponents believe that View B would result in cost savings in some acquisitions. Proponents point out that View B should not result in an increase in cost and complexity in any acquisitions compared to current U.S. GAAP.

31. Some opponents of View B are proponents of View A and believe that the value of intangible assets often does not provide decision-useful information to users of financial statements. As View B continues to recognize some intangibles apart from goodwill, they believe that preparers will be incurring costs to value some intangibles without significant benefit to users.

32. Other opponents of View B are proponents of View C and believe that depending on the industry, the value of intangible assets that cannot be sold or otherwise generate cash flows independently from the other assets of a business may still provide decision-useful information to users. For example, in many acquisitions, CRIs represent the core driver of the acquisition. Thus, subsuming those intangible assets into goodwill could deprive users of relevant information and impair their ability to evaluate management's capital

allocation decisions. In addition, some intangible assets are more relevant to certain industries than others.

33. Opponents highlight that while this alternative may reduce costs for some companies, it may not reduce costs for others or may not reduce costs significantly. These opponents believe that any change to current U.S. GAAP should be significant enough to warrant a difference between public companies and private companies and that the cost reduction should be significant to stakeholders broadly. Opponents believe that View B does not result in enough cost relief for private companies compared to current U.S. GAAP, because they believe that View B would result in identifiable intangible assets still being recognized, even if there are fewer than under existing guidance, and therefore would continue to require extensive involvement of external valuation professionals and auditors in many acquisitions.

34. Based on discussions with some valuation specialists, the reduction in cost and complexity associated with View B would depend on the facts and circumstances of individual acquisitions. Valuation specialists indicated that in some cases, View B would result in no intangibles being recognized. For example, for many acquisitions in the service and manufacturing industries, the only intangibles currently recognized are CRIs and NCIs. As such, View B would not necessitate any valuation specialist involvement in those cases for intangible assets (they might still be required for tangible assets). However, in those cases, sometimes the cost of the valuation specialist is not significant in the context of the cost of an acquisition. In other industries, such as technology and consumer products, View B could reduce costs but would likely still require the use of a valuation specialist and so the cost reduction could be insignificant. The valuation specialists interviewed by the staff were unable to indicate how significant the cost reduction would be without all of the other facts and circumstances of an acquisition.

### *View C*

35. Under View C, there is no change to U.S. GAAP. An entity would continue to recognize intangible assets acquired in a business combination separately from goodwill

on the date of acquisition. Such intangibles may include CRIs, customer contracts, trade names, brands, technology, patents, publishing rights, software, trade secrets, and IPR&D. A company would recognize these intangible assets at their acquisition-date fair values in accordance with Topic 805.

36. Proponents of View C believe that separately recognizing all identifiable intangibles from goodwill is more representationally faithful than allocating all or some intangibles to goodwill, which is consistent with the principle basis for the existing requirement to recognize intangibles separately from goodwill. When the current guidance was first introduced, the FASB specifically cited Concepts Statement 5, which states that "analysis aimed at objectives such as predicting amounts, timing, and uncertainty of future cash flows requires financial information segregated into reasonably homogenous groups." Based on that principle, and since goodwill would no longer be amortized, the Board concluded that intangibles that are identifiable (which was defined in a broad manner), should be separately recognized from goodwill. At the time, the FASB defined "identifiable" broadly because it believed that history of individual exchange transactions was not the only evidence of separability. Proponents acknowledge that the fair value estimates for some intangible assets might require more judgment than other assets. However, they also believe that the financial information that will be provided by recognizing all intangible assets at their fair values is more representationally faithful than that which would be provided if those intangible assets were subsumed into goodwill on the basis of measurement difficulties.

37. Some proponents believe that the "primary" asset, or the asset that is the main reason for the acquisition, should be recognized at fair value. Because that primary asset can be intangible assets, they believe that the relevance of financial reporting would be reduced if the model does not require recognition of such assets.

38. Some proponents of View C believe that the definition of what constitutes a CRI may be overly broad under current U.S. GAAP, but that the criteria for recognition under View B are too narrow. They believe that fair value information about customer

relationships that cannot be sold separately from a business may still be relevant to users, including customer contracts and subscription lists. However, they think that a case could be made that at-will customer relationships may not warrant recognition even if a company does have regular contact with those at-will customers. These proponents would support a broader project that would include all entities to re-assess certain intangible asset recognition concepts and believe that there may be a more reasonable middle-ground between View B and View C.

39. Some proponents of View C do not think significant costs are incurred associated with the valuation of intangibles recognized in a business combination. They observe that the costs are incurred only on the acquisition date. Those proponents observe that many users do find intangible assets to provide decision-useful information. Proponents also observe that there do not appear to be significant practice issues associated with current U.S. GAAP. The staff has not received any technical inquiries related to the issues addressed in this Issue Supplement in the last three years.

40. Opponents of View C have views consistent with those of proponents of View A and View B and believe that the benefits of the current accounting for identifiable intangible assets acquired in a business combination do not justify the related costs. In addition, as discussed in the proponent views for View A and View B, some users of financial statements indicated that they view many intangible assets as being no different than goodwill. Therefore, opponents of View C believe that an alternative that would reduce cost and complexity relating to identification of intangible assets in a business combination is warranted.

**PCC Question #1: Which View does the PCC support?**

**Issue 2: Recurring Disclosure**

41. Similar to the proposed Update, under View A and View B, an entity would be required to disclose qualitatively the nature of identifiable intangible assets acquired but

not recognized as a result of applying the accounting alternative. For intangibles that are recognized after applying the accounting alternative, a private company would follow the disclosure requirements in the relevant Codification Topics (for example, Topics 805; 350, Intangibles—Goodwill and Other; and 820).

#### *Feedback and Analysis*

42. The majority of respondents to the proposed Update agreed with the required additional disclosure to provide qualitative information about the nature of identifiable intangible assets acquired but not recognized as a result of applying the proposed alternative. Those respondents indicated that the disclosures would provide financial statements users with sufficient information about non-separately recognized intangible assets that would work as a signal to alert financial statement users to the existence of intangible assets that are subsumed into goodwill. Most users of private company financial statements could obtain further information from management about those intangible assets if necessary through their ability to access management.

43. A few respondents questioned the relevance of the proposed additional disclosure. If some intangible assets do not warrant separate recognition on the face of the financial statements, there should not be a need for disclosures about those assets. Other respondents expressed concern that the provision of such disclosures would add complexity and require private companies to likely involve third-party valuation experts to assist them with the identification of the additional intangible assets. This may defeat one of the goals of a proposed alternative, which is to reduce costs and complexity for private companies. A few respondents requested that the PCC clarify the periods in which the additional disclosures should be provided.

44. Nearly all respondents agreed that the proposed alternative should not require any other additional recurring disclosures for identifiable intangible assets that are recognized separately as a result of applying the proposed alternative.

45. Some preparers expressed concern that any cost savings associated with not separately recognizing certain intangibles would be offset by the costs of providing additional qualitative disclosures. Depending on how extensive the required disclosures are, some preparers noted they might prefer to continue simply recognizing the intangible assets at fair value rather than expanding qualitative disclosures.

46. If the PCC chooses View A or View B, the PCC should consider whether that an entity should be required to disclose qualitatively the nature of identifiable intangible assets that are not recognized separately from goodwill as a result of applying the proposed alternative. Disclosures would be required in the period of acquisition and annually thereafter. For identifiable intangible assets that are recognized separately from goodwill, entities would continue to follow the disclosure requirements in applicable topics. The Guide indicates that the Board and the PCC should consider whether there will be sufficient disclosure in the notes necessary to facilitate a user's review and to allow a user to identify appropriate follow-up questions to present to management (the red-flag approach) when the user deems it necessary to do so. Disclosure of qualitative information about intangible assets that are not recognized could provide useful information to users and help them identify items that could require further discussion with management without significant costs to preparers.

47. The objective of the disclosures could be for an entity to disclose sufficient information to enable users of financial statements to understand the nature of the intangible assets acquired in a business combination that have not been recognized separately from goodwill. To enhance those disclosures, the PCC should consider whether to prescribe specific disclosures for entities to include in their financial statements. Examples of the types of disclosures an entity may consider include:

- a. A description of the types of intangible assets that are not separately recognized
- b. Contract terms
- c. Attrition rate

- d. Length of non-compete agreements
- e. How the intangible asset will be used (whether the entity plans to license or sell the intangible)

This list is not intended to be all-inclusive. The examples are intended only to illustrate the objective of the qualitative disclosures. The PCC should consider whether the cost savings associated with not separately recognizing certain intangibles could be offset by the costs of requiring detailed additional qualitative disclosures.

**PCC Question #2: Does the PCC want to require that an entity that elects to apply the proposed alternative must disclose qualitatively the nature of identifiable intangible assets that are not recognized separately from goodwill as a result of applying the proposed alternative, and does the PCC not want to prescribe specific qualitative disclosures but, rather, provide some examples in the final Update?**

### **Issue 3: Transition**

48. The proposed Update indicates that the alternative would be effective prospectively for all business combinations entered into during fiscal years, and interim periods within those years, beginning on or after the effective date.

#### *Feedback and Analysis*

49. Nearly all respondents agreed that the proposed alternative should be applied on a prospective basis. Many respondents did not agree with the option of retrospective application due to cost and complexity considerations. However, a few respondents acknowledged that a retrospective application should be permitted on an elective basis for preparers and users who prefer consistent presentation of intangible assets in comparative financial statements. In addition, those respondents stated that retrospective application may not be practical unless an entity also adopts the PCC proposal on accounting for goodwill (Issue 13-01B).

50. The PCC should decide whether to reaffirm its tentative decision that an entity would apply the proposed alternative prospectively for all business combinations entered into after the effective date. A retrospective approach would require a private entity to restate all past intangibles and goodwill balances, along with the related amortization and impairment charges. That approach may be impracticable because of the retrospective judgments that would be necessary for such restatements (for example, restating goodwill impairment based on the changes to accounting for identifiable intangibles that would change the previously recognized goodwill amounts). A prospective approach, in which the differential accounting treatment would only apply to new business combinations after the effective date, could be more appropriate. Some stakeholders may prefer the option of retrospective application in order to achieve comparability. However, the proposed alternative is intended to reduce costs and complexity while improving the relevance of information to users. Retrospective application would most likely result in additional effort and cost to be incurred by preparers.

**PCC Question #3: Does the PCC wish to reaffirm its decision that if elected, the alternative should be applied prospectively for all business combinations entered into after the effective date with no option to apply retrospective application?**

*Method of prospective recognition*

51. To help identify the method of prospective recognition for intangible assets that exist at the beginning of the period of adoption, the FASB staff has identified the following alternatives to account for separately-recognized intangible assets existing as of the beginning of the period of adoption:

*View A: Continue to recognize and measure intangible assets that exist as of the beginning of the period of adoption in accordance with existing U.S. GAAP in Topic 350.*

*View B: Under the proposed alternative, any intangible asset that exists as of the beginning of the period of adoption would no longer be separately recognized and would be subsumed into goodwill.*

52. The primary differences between View A and View B relates to subsequent measurement. Under View A, any existing intangible asset would continue to be amortized (except for indefinite lived intangible assets) and subject to the impairment test under Topic 350. Under View B, pending the PCC's decision to link Issue 13-01A with Issue 13-01B, an entity would either

- a. Subsequently measure and account for goodwill by amortizing goodwill on a straight-line basis over a 10-year period, or less than 10 years if the entity demonstrates that another useful life is more appropriate. The entity would also be subject to a simplified impairment test.
- b. If an entity elects not to apply PCC Issue No. 13-01B, goodwill would continue to be recognized in accordance with existing U.S. GAAP and would be subject to an annual impairment test and would not be amortized (pending the Board's decisions in its project on accounting for goodwill for PBEs and NFPs).

53. View A would result in less cost for a private company and would also provide more relevant information for users. Under View A, preparers would not need to evaluate the potential impact of a change in the subsequent accounting for goodwill and the time and effort to change the accounting. In addition, the current amortization period for those intangible assets could be more appropriate than amortizing over a 10-year period (or the period goodwill is amortized over) and could more appropriately reflect the economics of the transaction.

**PCC Question #4: Which View does the PCC prefer?**

**Issue 4: Effective date and early application**

54. The proposed Update did not indicate an effective date for the proposed alternative but does indicate that that early application would be permitted.

*Feedback and Analysis*

55. The majority of respondents indicated that the proposed alternative should become effective within a short period of time after final issuance. Some respondents indicated that the effective date should be one year after issuance to provide private companies with sufficient time to prepare and understand the implications of the changes given that they will not have the benefit of learning from public companies. Nearly all respondents were supportive that early application should be permitted.

56. The PCC should decide whether private companies should be able to apply the alternative, if elected, to account for intangible assets in a business combination entered into in the first annual period beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016. Early application should be permitted for any annual or interim period for which the entity's annual or interim financial statements have not yet been made available for issuance. If the proposed alternative is final before the end of 2014, private companies and their auditors would have almost two years from issuance before the issuance of a calendar year private company's financials to implement the new guidance, but also provide an opportunity for those that wish to be able to apply the guidance earlier. Making the guidance effective in 2016 (for calendar year companies) acknowledges the fact that private companies and their auditors often do not learn about new guidance until later in the year and that the final standard may be issued while their resources are focused on year-end close and other matters. For entities that prefer to elect to apply the proposed alternative before the effective date, a benefit is that they will have the option of early adoption.

**PCC Question #5: Does the PCC think that the proposed alternative should be effective for business combinations entered into in the first annual period beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016? If not, what effective date do they suggest?**

**PCC Question #6: Does the PCC wish to reaffirm its decision that the proposed alternative should permit early adoption for any annual or interim period for which**

**the entity's annual or interim financial statements have not yet been made available for issuance?**

**Issue 5: Linkage with PCC Issue No. 13-01B, "Accounting for Goodwill for Private Companies"**

57. At its October 2013 meeting, the PCC decided to move forward with the alternative for the accounting for goodwill under Issue 13-01B without linking its adoption to the outcome of this Issue (Issue 13-01A).

58. Depending on the decisions on the views presented in this Issue Supplement, the PCC will need to decide whether Issue 13-01A should be linked to Issue 13-01B. The staff has identified the following alternatives for the PCC's consideration:

*View A: Election of Issue 13-01A requires the adoption of Issue 13-01B.*

59. Proponents of View A believe that linking Issue 13-01A to Issue 13-01B provides a mechanism for assets that are finite-lived to be amortized. Further, proponents of View A believe that because Issue 13-01A would likely result in a higher goodwill balance in comparison to current U.S. GAAP, entities would be exposed to a higher risk of goodwill impairment. Therefore, by linking the adoption of Issue 13-01A to Issue 13-01B, a private company would reduce its risk for goodwill impairment by amortizing goodwill in addition to the changes made to simplify the impairment test.

60. Opponents of View A are proponents of View B.

*View B: Election of Issue 13-01A does not require the adoption of Issue 13-01B.*

61. Proponents of View B believe that both Issue 13-01A and Issue 13-01B independently would result in a reduction in cost and complexity while resulting in decision-useful information for users of private company financial statements and,

therefore, believe that the Issues should not be required to be linked. Proponents also believe that View B could limit the number of differences within U.S. GAAP between private companies and PBEs because an entity would not be required to apply both proposals.

62. Opponent of View B are proponents of View A.

63. Issue 13-01A has a clear interdependency with Issue 13-01B because any change to current U.S. GAAP that would result in an entity recognizing fewer intangible assets in a business combination would result in that entity recognizing a larger amount of goodwill (because goodwill is the residual asset). Under current U.S. GAAP, goodwill is not amortized. Therefore, if Issue 13-01A is not linked to Issue 13-01B, for private companies that do not elect Issue 13-01B, fewer intangible assets recognized on the acquisition date would result in less amortization expense (and higher earnings) in the post-acquisition periods as compared to current U.S. GAAP.

**PCC Question #7: Which Alternative does the PCC support?**

**Issue 6: Whether the proposed Update should be revised and reexposed.**

64. The PCC should consider whether to reexpose this Issue based on the changes to the proposed alternative as a result of the decisions reached on the questions above. According to the staff analysis, reexposure is generally required when there has been a substantive change to the scope or to the primary recognition, measurement, or disclosure principles. The intention of a reexposure is to allow constituents to have an opportunity to raise issues or concerns not previously considered by the PCC. The need to issue a revised exposure draft is a matter of judgment, taking into consideration various factors, including:

- a. The extent to which decisions reached during redeliberations of an exposure draft result in a substantive change to the guidance proposed in the exposure draft on which respondents commented (individually and/or in the aggregate).
- b. Whether stakeholders have had sufficient opportunity to fully consider the implications of the change and communicate their views on the change (for example, through comment letters and constituent outreach activities during redeliberations).
- c. Whether the decision making of the Board or the PCC would benefit from additional input on the change, considering the extent to which such input would provide new information not previously considered by the Board or the PCC prior to redeliberations.
- d. The time that has lapsed since issuance of the exposure draft and the effect of economic, regulatory, or other changes during the intervening period on the arrangements that are the subject of the exposure draft.

65. After considering those factors, if the PCC decides to move forward with View A or View B of Issue 1, the staff believes that exposure of a revised exposure draft is warranted.

66. The FASB staff notes that if reexposure is required, the summary of comments from the re-exposed proposed Update could be considered by the third quarter and the Update could be finalized before the end of 2014. That would enable entities that choose to elect early adoption to take advantage of the relief in their 2014 financial statements if the financial statements have not yet been issued (as calendar-year private company financial statements are often not issued until April or May).

**PCC Question #8: Does the PCC believe that the proposed Update should be reexposed?**

## Board Meeting Handout

### 3. PCC Issue No. 13-02, "Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements," Issue Summary No. 1, Supplement No. 2

January 22, 2014

#### PCC Issue No. 13-02

**Title:** Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements

**Document:** Issue Summary No. 1, Supplement No. 2\*

**Date Prepared:** January 14, 2014

**FASB Staff:** Michael Cheng (203-956-5236) / Rahul Gupta (203-956-5317) / Karlene Tipton (203-956-5264)

**Dates previously discussed:** February 12, 2013; July 16, 2013; November 12, 2013

**Previously distributed PCC materials:** Agenda Request Issue No. 1, dated February 1, 2013; Issue Summary No. 1, dated May 7, 2013; Issue Summary No. 1 (Revised), dated July 16, 2013; Proposed Accounting Standards Update, dated August 22, 2013; Issue Summary No. 1, Supplement No. 1, dated November 1, 2013

#### Purpose

1. At its November 12, 2013 meeting, the PCC voted to finalize an accounting alternative within U.S. GAAP for private companies in applying variable interest entity (VIE) guidance to lessor entities under common control. Subsequent to the November 12, 2013 meeting, private company stakeholders raised concerns that the conditions that

---

**\* The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the PCC. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the PCC makes such a determination, exposes it for public comment, and it is endorsed by the Board.**

---

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

should exist to qualify for the accounting alternative under Issue No. 13-02 may be too restrictive, potentially scoping out many entities that were originally expected to benefit from the issuance of this guidance. The purpose of this Issue Summary Supplement is to provide additional analysis and potential alternatives to consider for addressing the concerns raised by those private company stakeholders.

## **Background**

### ***Summary of PCC Accounting Alternative***

2. Current U.S. GAAP requires a reporting entity to consolidate a VIE when that reporting entity is considered to be the primary beneficiary of the VIE. As a result, VIE guidance could, in certain circumstances, require a reporting entity (lessee) to consolidate a lessor entity when both entities are under common control. The PCC decided that when the arrangement between a private company lessee and a lessor entity meets certain conditions, the private company lessee can elect the alternative and not apply the VIE guidance to the lessor entity.
3. Under the accounting alternative, all of the following conditions should be present to qualify for this accounting alternative:
  - a. The private company lessee and the lessor entity are under common control
  - b. The private company lessee has a leasing arrangement with the lessor entity
  - c. Substantially all of the activity between the two entities is related to the leasing activity of the lessor entity
  - d. The obligations of the lessor entity, if any, are only collateralized by the assets leased by the private company lessee and not by assets of the private company lessee.
4. In applying this alternative, a private company would replace VIE disclosures about the lessor entity with both of the following:
  - a. Disclosures about the amount and key terms of significant liabilities recognized by the lessor entity that expose the private company to having to provide significant financial support to the lessor entity

- b. A qualitative description of significant arrangements not recognized that expose the private company to having to provide financial support to the lessor entity.

5. While VIE guidance would no longer apply to the lessor entity, a private company would still have to consider other applicable U.S. GAAP, such as Topic 460, Guarantees, and Topic 840, Leases, for transactions or arrangements related to the leasing activity between the two entities.

**Issue 1: Criterion (d) to Qualify**

6. Private company stakeholders have expressed concern about the criterion included in paragraph 3(d) above being too restrictive. This criterion would require the obligations of the lessor entity, if any, to only be collateralized by those *assets that are leased* by the private company lessee and not by *any other assets* of the private company lessee. The staff has identified the following alternatives for the PCC to consider as it addresses the issue raised in this Supplement.

*View 1: Keep criterion (d)*

7. Under View 1, the obligations of the lessor entity, if any, are only collateralized by the assets that are leased by the private company lessee and not by any other assets of the private company lessee in order for a private company to meet the criterion to apply the accounting alternative.

8. Proponents of View 1 argue that this criterion is effective in preventing the use of lessor entities solely for the purpose of inappropriately avoiding on-balance sheet reporting (“structuring opportunities”). Proponents argue that without this criterion, a private company and lessor entity with cross collateralization could structure an arrangement under which liabilities are taken on by the lessor entity on behalf of the private company lessee. Therefore, proponents of View 1 advocate limiting the collateral to only assets leased by the private company lessee to prevent structuring opportunities.

9. Opponents of View 1 believe that the criterion is too restrictive because cross-collateralization is an ubiquitous arrangement for entities under common control. Therefore, many private companies would not benefit from applying the accounting alternative and, thus, continue to be subject to existing guidance. Furthermore, opponents of View 1 believe that the goal of limiting structuring opportunities by the addition of this criterion is not achieved because the common control owner of the private company and lessor entity could still have an explicit guarantee on the lessor entity's obligations. While a guarantee is not asset specific, it could be used as a substitute for cross-collateralization to satisfy some lenders.

*View 2: Replace criterion (d) with: The performance on any guarantee or collateral arrangement related to the lessor company is remote*

10. Under View 2, the performance on any guarantee or collateral arrangement related to the lessor company must be remote for a private company lessee to apply the accounting alternative. In other words, a private company lessee would be required to apply VIE guidance to a lessor entity under common control when the likelihood that the performance of a guarantee or collateral arrangement related to the lessor entity under common control is less than remote. Another approach to implement View 2 could be a change in the criterion's threshold, for example, from remote to more-likely-than-not or probable. If the PCC considers this alternative, the staff would suggest that a timeframe be added to the criterion to make the alternative more operational. For example, View 2 could include a timeframe with the criterion that considers the likelihood of performance over the next 12 months. With the criterion's threshold set at remote and without a stipulated timeframe, the staff believes View 2 is likely to be more restrictive than the remaining views presented in this Issue Supplement.

11. Proponents of View 2 believe that this criterion is highly effective in preventing structuring opportunities while not precluding all arrangements in which there are guarantees or collateral arrangements related to the lessor entity. Furthermore, the threshold of remote exists in current GAAP today and is well understood.

12. Opponents of View 2 agree that the threshold of remote is well understood, but argue that this criterion would be too difficult to assess. Those opponents argue that even if a private company could assess the likelihood of the performance of a guarantee or collateral arrangement, the assessment would be subjective and difficult to support when subjected to audit. Some opponents also believe that it would be virtually impossible to claim that the likelihood of performance on a guarantee or collateral arrangement is remote. Furthermore, opponents argue that the likelihood of performance on a guarantee or collateral arrangement related to the lessor entity would not affect the assessment of consolidation under VIE guidance.

*View 3: Replace criterion (d) with: Substantially all of the lessor entity's activities consist of either leasing to the entities under common control or the support of leasing.*

13. View 3 allows a private company lessee to apply the accounting alternative if substantially all of the lessor entity's activities consist of either leasing to the entities under common control or the support of leasing. The term "substantially all" is intended to be consistent with the threshold under criterion (c) to qualify for the accounting alternative—that is, the threshold is intended to be fairly high. View 3 would preclude private companies from applying the accounting alternative if substantially all of the lessor entity's activities do not consist of either leasing to the entities under common control or the support of leasing.

14. Proponents of View 3 believe that the criterion would be easy to apply. Proponents also argue that View 3 would still provide relief to a significant number of private companies when compared to View 1 or View 2. Proponents also argue that View 3 limits structuring opportunities to leasing activity and would be effective in preventing structuring opportunities through the use of activities other than leasing.

15. Opponents of View 3 argue that a greater level of leasing activity by the lessor entity to unrelated parties generally decreases the likelihood of consolidation under the current

VIE model. In applying VIE guidance, most agree that it is less likely that a private company lessee would have power over a lessor entity under common control because there are more unrelated parties leasing from the lessor entity. Those unrelated parties could prevent the private company from making decisions that only benefit itself and could indicate that the lessor entity's activities are less aligned with the private company lessee. Under View 3, private companies leasing from entities with unrelated leasing activity could perform a comprehensive VIE analysis of situations that likely would result in no consolidation. Other opponents argue that View 3 is not restrictive enough to effectively address potential structuring opportunities.

*View 4: Replace criterion (d) with: Substantially all of the lessor entity's activities consist of either leasing or the support of leasing.*

16. View 4 is similar to View 3 except it permits private companies to apply the accounting alternative when lessor entities conduct leasing activities unrelated to the private company. For example, under View 4, a lessor entity could lease several floors of an office building to the private company and lease the remaining floors to an unrelated third-party lessor and still qualify for applying the accounting alternative assuming the first three criteria are met. This view provides relief from applying the existing guidance when the likelihood of consolidation under the VIE model is low due to the volume of leasing activity with unrelated parties. However, View 4 could allow a private company lessee to avoid consolidating significant leasing operations in which it has a controlling financial interest by structuring them to be included in an entity with which the private company lessee has a leasing arrangement.

*View 5: Remove criterion (d)*

17. Proponents of View 5 believe that the first three criteria suffice as a practical expedient for private companies who would likely not consolidate the lessor entity. Proponents of View 5 believe that a private company generally would not be considered the primary beneficiary of a lessor entity under common control. In identifying the

primary beneficiary, a reporting entity only proceeds to a related-party tie breaker *in situations in which a reporting entity concludes that neither it nor one of its related parties have the characteristics of a primary beneficiary.*<sup>1</sup> Those proponents argue that the parent of entities under common control is generally the primary beneficiary because it generally has (a) the power to direct the activities that most significantly impact the lessor entity's economic performance and (b) the obligation to absorb losses or the right to receive benefits of the lessor entity that could be potentially significant to the lessor entity.

18. Proponents of View 5 also agree with feedback that the disclosures under the accounting alternative would deter the use of this accounting alternative to structure off-balance sheet debt arrangements.

19. Opponents of View 5 disagree with the application of VIE guidance as described in paragraph 17 above. Those opponents do not believe that the parent of entities under common control is generally the primary beneficiary. Opponents of View 5 believe that the original three criteria along with the disclosures are not sufficient to prevent a proliferation of structuring activity.

**Question 1 for the PCC: Which alternative view does the PCC prefer?**

---

<sup>1</sup> Paragraph 810-10-25-44

## Board Meeting Handout

### 4. PCC Issue No. 13-03B, Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Combined Instruments Approach," Issue Summary No. 1, Supplement No. 2

January 22, 2014

#### PCC Issue No. 13-03B

**Title:** Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—  
Combined Instruments Approach

**Document:** Issue Summary No. 1, Supplement No. 2\*

**Date Prepared:** January 16, 2014

**FASB Staff:** Ryan Egan (203-956-3421)

**Dates previously discussed:** September 30, 2013; October 1, 2013; November 12, 2013

**Previously distributed materials:** Agenda Request Issue No. 3, dated February 13, 2013; Issue Summary No. 1, dated May 7, 2013; Proposed Accounting Standards Update, dated July 1, 2013; Issue Summary No. 1, Supplement No. 1, dated September 20, 2013

#### Purpose

1. This Issue Summary Supplement provides (a) a summary of outreach activities undertaken related to the combined instruments approach set forth in proposed Accounting Standards Update, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps*, issued on July 1, 2013, and (b) the staff's analysis for the combined instruments approach as a result of the feedback received. This Issue Supplement should be considered in conjunction with Issue Supplement No. 1, dated September 20, 2013,

---

**\* The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the PCC. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the PCC makes such a determination, exposes it for public comment, and it is endorsed by the Board.**

---

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

which was prepared for the September 30-October 1, 2013 Private Company Council (PCC) meeting.

## **Background**

2. The PCC received input through outreach indicating that private companies often find it difficult to obtain a fixed-rate borrowing. Therefore, some private companies enter into receive-variable, pay-fixed interest rate swaps (“swap”) to economically convert their variable-rate borrowings into fixed-rate borrowings. Under U.S. generally accepted accounting principles (GAAP), a swap is a derivative instrument. Topic 815, Derivatives and Hedging, requires that an entity recognize all of its derivative instruments on its balance sheet as either assets or liabilities and measure them at fair value. To mitigate the income statement volatility of recording a swap at fair value, Topic 815 permits an entity to elect hedge accounting if certain requirements under that Topic are met. Some private company stakeholders contend that because of limited resources and/or the difficulty in understanding and applying hedge accounting, many private companies lack the expertise needed to comply with the requirements to qualify for hedge accounting. Therefore, they do not elect to apply hedge accounting, which results in income statement volatility. In addition, some stakeholders question the relevance and cost associated with determining and presenting the fair value of a swap that is entered into for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing.

3. At its May 7, 2013 meeting, the PCC reached a decision to allow private companies, except financial institutions, to use two simpler alternative approaches to account for certain types of interest rate swaps that are intended to economically convert a variable-rate borrowing into a fixed-rate borrowing: (a) the combined instruments approach; and (b) the simplified hedge accounting approach, which addresses a potentially broader set of transactions than the combined instruments approach. On June 10, 2013, the Board endorsed the decision of the PCC, leading to the issuance of a proposed Update (the “Original Proposal”), which was exposed for public comment on July 1, 2013. The Board invited all interested parties to comment on all matters in the Original Proposal.

4. For the combined instruments approach, the following criteria were included in paragraph 815-50-15-2 of the Original Proposal:

- a. Both the variable rate on the swap and the borrowing are based on the same index and interest rate (for example, 1-month LIBOR).
- b. The terms of the swap are typical (in other words, the swap is what is generally considered to be a “plain-vanilla” swap, even though that term is not defined), and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a comparable floor or cap.
- c. The repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days.
- d. The swap’s fair value at inception (that is, at the time of application of the simplified hedge accounting approach) is at or near zero.
- e. The swap is not a forward-starting swap.
- f. The notional amount of the swap is equal to or less than the principal amount of the borrowing.
- g. The term of the swap approximates the term of the borrowing.
- h. The swap is effective at the same time as the borrowing or within a few days.

5. At its September 30-October 1, 2013 meeting, the PCC voted to finalize the simplified hedge accounting approach, subject to Board endorsement. It was endorsed by the Board and issued as a final Update<sup>1</sup> on January 16, 2014. The PCC did not finalize the combined instruments approach alternative and instead decided to separate the combined instruments approach from the Original Proposal and directed the FASB staff to conduct further research.

6. At its November 12, 2013 meeting, the PCC was provided with a preliminary summary of the staff’s research findings and discussed considerations related to potential alternatives for the combined instruments approach. The PCC directed the staff to continue researching the viability of the combined instruments approach with a focus on whether the alternative should include additional criteria.

### **FASB Staff Analysis**

---

<sup>1</sup> FASB Accounting Standards Update No. 2014-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach*

7. The staff conducted outreach with stakeholders including auditors of private companies, as well as users and preparers of private company financial statements. In the paragraphs that follow, the staff summarizes the significant findings from this outreach.

## Overall Scope

### *Conflicting Viewpoints*

8. In the Original Proposal, constituents were asked to comment on whether they support the criteria that must be met to qualify for the combined instruments approach. In addition to providing views on the qualifying criteria, several respondents expressed an opinion about whether they agree or disagree with the conceptual basis of the combined instruments approach. Generally, the largest accounting firms opposed the combined instruments approach due to a concern that applying the proposed accounting alternative would result in a fundamentally different conceptual basis for preparing financial statements of private companies as compared to public business entities. In particular, constituents opposing the combined instruments approach expressed concern that the approach reintroduces the concept of synthetic instrument accounting<sup>2</sup>, which was rejected by the Board at the time it issued Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Furthermore, opponents of the combined instruments approach questioned whether providing private companies with a new alternative to account for derivatives in addition to the hedge accounting alternatives that are already permitted under U.S. GAAP (that is, the shortcut, the simplified hedge accounting, and the long haul methods) would result in comparability issues for users of private company financial statements and add unintended complexity for preparers because of a multiplicity of alternatives.

9. Other constituents responding to the Original Proposal, including professional accounting organizations and accounting firms other than the largest firms, were generally supportive of the combined instruments approach. Those constituents believe that the combined instruments approach is supportable because, they contend, differences

---

<sup>2</sup> Paragraph 349 of the basis for conclusions of Statement 133 indicates that under synthetic instrument accounting, two or more distinct financial instruments (for example, a variable-rate debt and a receive-variable, pay-fixed interest rate swap) are viewed as having synthetically created another single financial instrument (for example, a fixed-rate debt).

exist in the user needs and preparer resources for private companies when compared to public business entities. The differences those constituents cite are consistent with the characteristics of private companies as described in the Private Company Decision-Making Framework, which states, among other factors, that preparers of private company financial statements generally do not have the same level of accounting resources as public business entities have. Supporters also note that because the combined instruments approach is a scope exception to the current derivatives and hedging guidance, it provides a reduction in complexity because preparers do not need to understand all of the requirements of Topic 815 to apply the approach. These supporters also note that private companies applying the approach would not be subject to contemporaneous documentation requirements that many private company stakeholders contend are overly burdensome. In addition, supporters believe the approach addresses private company stakeholder concerns about the volatility associated with recording the fair value of a swap that is entered into for the purpose of economically converting a variable-rate borrowing to a fixed-rate borrowing.

10. Based on the conflicting viewpoints discussed above, the staff conducted further research on the combined instruments approach and evaluated whether any revisions to the Original Proposal might alleviate the conceptual issues raised by opponents. To conduct that research, the staff performed outreach with auditors of private companies, users, and preparers, and analyzed whether additional criteria would result in a more appropriate conceptual basis for portraying a swap and a variable-rate borrowing as a single combined instrument while maintaining relevant information for private company financial statement users and also meeting the objective of reducing the cost and complexity of accounting for certain types of swaps.

#### *Conceptual Issues*

11. The staff notes that, in theory, an arrangement meeting the combined instruments approach criteria would likely be assessed as highly effective as long as each of the respective criteria continue to be subsequently met for the entire term of the borrowing. The staff notes, however, that there are several potential scenarios under which a

perfectly-matching interest rate swap and a variable-rate debt may cease to be effective during the term of the borrowing. The following potential scenarios were identified whereby an arrangement meeting the combined instruments approach criteria would cease to be effective subsequent to inception<sup>3</sup>:

- a. The debt is prepaid prior to the termination or maturity of the swap.
- b. The swap is terminated early without the debt being prepaid.
- c. The borrower refinances its debt prior to maturity.
- d. Any event of a borrower or swap counterparty default.

12. For a private company applying the combined instruments approach, any of the above scenarios would result in a triggering event requiring the initial recognition of a swap asset or liability that had not been previously recognized. This initial recognition of a previously unrecognized asset or liability in the balance sheet and/or income statement could be confusing to financial statement users and could lead to unanticipated balance sheet and income statement volatility. Proponents of the combined instruments approach argue that terminating a swap without a corresponding prepayment of the borrowing or, alternatively, a prepayment of the borrowing prior to the termination or maturity of the swap, would occur infrequently because those scenarios would be contrary to the private company's objective of economically obtaining a fixed-rate borrowing. On the other hand, opponents contend that early terminations of the swap may result from events that could not have been reasonably anticipated, such as an unexpected and urgent need for capital to avoid filing for bankruptcy. The staff's outreach indicated that although many private companies hold their swap until maturity, they may decide to terminate a swap in an asset position if they are comfortable with variable interest rates. Furthermore, the staff's outreach indicated that many private companies exit a hedging relationship early because they do not wait until their existing facility terminates to refinance or extend the term of the borrowing. The staff notes that an early debt refinancing would result in the discontinuance of the combined instruments approach but would also likely occur near the end of the borrowing term when the swap's fair value may be immaterial.

---

<sup>3</sup> This list is not inclusive of all scenarios that might introduce ineffectiveness into a cash flow hedging relationship.

### *Counterparty Considerations*

13. The staff notes that the conceptual issues discussed above are more problematic for private companies with arrangements in which the counterparties to the loan and swap are different entities. This is the case in arrangements in which the lender serves as an intermediary between the swap counterparty and the borrower or the borrower contracts directly with a third party to obtain a swap. Often times, however, private companies enter into a swap in which their lender is also the swap counterparty. For single lending arrangements in which the lender is also the swap counterparty, counterparty credit risk is reduced due to the fact that only two counterparties are involved in the transaction (that is, the lender and the borrower) instead of three (that is, the lender, the borrower, and a third-party swap dealer). In addition, when the lender is the swap counterparty, complexity is reduced because same counterparty loan and swap arrangements often include standard cross-collateral and cross-default provisions. Swap counterparties that are not lenders, on the other hand, may need to develop customized provisions in order to obtain collateral that is not already encumbered by the loan. The difficulty in obtaining unencumbered collateral makes arrangements for which different entities are counterparties to the loan and swap less common in practice.

14. The staff also researched the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which is currently being implemented. The new law calls for most derivative trading, including trading in interest rate swaps, to be moved to clearinghouses. Constituents noted that the Dodd-Frank Act is causing a shift in industry practice whereby loan and swap arrangements involving different counterparties are increasingly rare for private companies. One impactful change is the revised definition of an Eligible Contract Participant (“ECP”). In order to write a swap, financial institutions must verify that their customer meets ECP requirements, which includes confirming that the customer has greater than \$10 million in total assets, has greater than \$1 million in net worth, or meets other specific minimum thresholds. Confirming that a private company meets the ECP requirements is costly for a swap counterparty that is not also a lender because in order to write a swap, a third party would need to perform additional due diligence since it may not know the private company’s financial

information. The Dodd Frank Act also contains numerous administrative requirements that need to be met in order to enter into a swap that is not centrally cleared. For example, a private company entering into a swap transaction will need to obtain a legal identifier, provide notification to the Commodity and Futures Trading Commission that it has entered into a swap, and elect an end-user exception to swap clearing requirements, which requires approval from the private company's Board of Directors. The staff's outreach indicated that the cost of complying with those administrative requirements would likely deter private companies from entering into a swap with an entity that is unaffiliated with their lender.

### *Linked Transactions*

15. In evaluating counterparty considerations, the staff researched broadly whether Topic 815 contains any precedent to combine separate transactions involving the same counterparty. Generally, Topic 815 is designed to be applied to individual transactions to determine whether the transaction should be accounted for as a derivative. However, the staff identified certain limited circumstances in Topic 815 under which an entity could enter into two or more legally separate transactions that are "linked" due to the fact that they involve the same counterparty. In particular, the staff identified DIG Issue No. K1, *Determining Whether Separate Transactions Should Be Viewed as a Unit* ("DIG Issue K1"), which is codified in paragraph 815-10-15-9.<sup>4</sup> DIG Issue K1 provides criteria to assess whether two or more separate derivative transactions are structured to circumvent Topic 815 and stipulates that the derivative contracts should be viewed as a unit rather than separately. The staff acknowledges that circumstances under which the combined instruments approach might be applied would not be analogous to arrangements contemplated by DIG Issue K1 because there is a substantive business purpose for entering into a swap and loan separately. The example is informative, however, due to the

---

<sup>4</sup> Paragraph 815-10-15-9 states that if two or more separate transactions may have been entered into in an attempt to circumvent the provisions of Topic 815, the following indicators shall be considered in the aggregate and, if present, shall cause the transactions to be viewed as a unit and not separately:

- a. The transactions were entered into contemporaneously and in contemplation of one another.
- b. The transactions were executed with the same counterparty (or structured through an intermediary).
- c. The transactions relate to the same risk.
- d. There is no apparent economic need nor substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

fact that it allows transactions to be linked as a unit in instances in which separate transactions are “executed with the same counterparty (or structured through an intermediary).”

### *Right of Setoff*

16. Conceptually, an arrangement involving separate legal contracts with the same counterparty would not be offset without meeting the requirements of FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, which is codified in paragraph 210-20-45-1.<sup>5</sup> As such, the staff performed outreach with banks and swap dealers to evaluate whether the conditions for a right of setoff under Interpretation 39 might exist in an arrangement involving the same counterparty on a swap and borrowing.

17. The staff’s outreach indicated that such an arrangement would not meet the criteria for the right of setoff. One constituent noted that this is the case even in a cross-collateralized loan and swap arrangement with a cross-default provision. That constituent acknowledged that, from an administrative perspective, there may be a consolidated invoice provided by the bank to the borrower that aggregates periodic payments on the loan and swap (that is, the accrual balance each period). However, the constituent clarified that the bank provides a consolidated invoice for administrative purposes and that it does not mean that these periodic payments offset from a legal perspective. This constituent also noted that the borrower does not have a legal right to offset the fair value of the swap against either periodic interest payments or the loan’s principal balance. Furthermore, although many agreements contain a “setoff clause” that lets the lender offset amounts owed to the borrower against the outstanding loan balance in the event of a borrower default, there is no corresponding right for the borrower to withhold loan payments in the event that their swap counterparty defaults. As a result, the staff believes

---

<sup>5</sup> Paragraph 210-20-45-1 states that a right of setoff exists if the following conditions are met:

- 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.

that adding a requirement to the combined instruments approach regarding the right of setoff would not be a viable alternative.

#### *Alternative Views*

18. Because having the same counterparty alleviates some of the conceptual issues identified under the combined instruments approach, and because same counterparty arrangements are common in practice, the staff believes it is important to consider adding a requirement to the combined instruments approach criteria that the swap and related variable-rate borrowing involve the same counterparty. If a same counterparty criterion is added, however, the staff believes it is also important to consider whether the requirement should be limited to the same “legal entity” or, alternatively, the same “legal entity or affiliate”. As such, the staff considered the following two alternative views:

#### ***View A—Same Legal Entity***

The combined instruments approach should be applied only to arrangements in which the same legal entity is both the lender and the swap counterparty. Proponents of View A note that for many small financial institutions, such as community banks<sup>6</sup>, the same legal entity provides the loan and swap because those smaller lending institutions do not have complex legal entity structures. As a result, proponents of View A believe that adding a same legal entity criterion would restrict application of the combined instruments approach to a sufficiently narrow set of circumstances under which some of the conceptual issues identified for the approach might be alleviated.

#### ***View B—Same Legal Entity or Affiliate***

The combined instruments approach should be applied only to arrangements in which the same legal entity or affiliate<sup>7</sup> is both the lender and the swap counterparty. Proponents of View B note that many large financial institutions operate within complex organizational structures that involve multiple legal entities. As such,

---

<sup>6</sup> For this purpose, community banks are defined as a bank having less than \$10 billion in total assets.

<sup>7</sup> The Master Glossary definition of “affiliate” is as follows: “A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity.”

Proponents of View B note that a same legal entity criterion may unduly limit the scope of applying the combined instruments approach. Proponents of View B believe that allowing for an affiliate would appropriately broaden the scope of the proposed criterion to include arrangements involving separate but affiliated legal entities while still alleviating some of the conceptual issues that were identified for the approach.

***View C— Keep Current U.S. GAAP***

The combined instruments approach should not be finalized by the PCC based on the conceptual issues identified for the approach. Proponents of View C note that the swap and related variable-rate borrowing involve separate legal contracts that do not meet the requirements for a right of setoff. These proponents believe that the conceptual issues identified for the approach will continue to exist even if a requirement is added to the criteria that the swap and borrowing involve the same counterparty. Proponents of View C also believe that the simplified hedge accounting approach, which was issued as a final Update, is sufficient to meet the PCC's goal of providing relevant information to private company financial statement users and in reducing the cost and complexity of applying hedge accounting for private companies. Further, the combined instruments approach does not provide enough incremental benefit in terms of providing relief to private companies to justify an exception from the fundamental concept in Topic 815 to report all derivatives in the financial statements.

19. For the alternatives above, the staff conducted outreach with community banks that are more likely to offer a loan and swap agreement from the same legal entity because they do not have a complex legal entity structure. The staff's outreach indicated that community banks do not frequently write interest rate swaps (one constituent noted that approximately one in six community banks hold an interest rate swap). For larger financial institutions, on the other hand, the staff's outreach indicated that it is a common practice to provide interest rate swaps to private companies. Due to various banking regulations, however, larger financial institutions frequently offer a loan from a bank

holding company and offer a swap, which may not be subject to the same regulation as lending practices, from a broker dealer. Therefore, the loan and swap agreements may be with different legal entities, even if those legal entities operate under the same holding company or are affiliated through common ownership or business practices.

**PCC Question #1: Which view does the PCC prefer? If a same counterparty criterion is added, should the requirement be limited to the same “legal entity” (View A) or limited to the same “legal entity or affiliate” (View B)?**

#### Other Scope Considerations

##### *Conforming Edits*

20. Paragraph 815-20-25-131D, which was added by Update 2014-03, includes the following requirements to qualify for the simplified hedge accounting approach. These criteria are equally relevant to the combined instruments approach. The criteria were modified from the Original Proposal according to commentary received from constituents prior to the issuance of the final Update permitting use of the simplified hedge accounting approach:

- a. Both the variable rate on the swap and the borrowing are based on the same index and reset period (for example, both the swap and borrowing are based on one-month London Interbank Offered Rate [LIBOR] or both the swap and borrowing are based on three-month LIBOR). In complying with this condition, an entity is not limited to benchmark interest rates described in paragraph 815-20-25-6A.
- f. All interest payments occurring on the borrowing during the term of the swap (or the effective term of the swap underlying the forward starting swap) are designated as hedged whether in total or in proportion with the principal amount of the borrowing being hedged.

21. The staff identified revisions to the combined instruments approach criteria in order to conform it to the relevant criteria that are included in paragraph 815-20-25-131D. These conforming edits were identified in the review of the draft final Update for the simplified hedge accounting approach. The staff notes the edits do not alter the applicability of the combined instruments approach but are instead suggested in order to provide additional clarification within the respective criteria. Specifically, the following

conforming edits were identified for the paragraphs below (added text is underlined and deleted text is ~~struck out~~):

**815-50-15-2(a)** Both the variable rate on the swap and the borrowing are based on the same index and interest rate (for example, ~~1-month LIBOR~~) both the swap and borrowing are based on one-month London Interbank Offered Rate [LIBOR] or both the swap and borrowing are based on three-month LIBOR). In complying with this condition, an entity is not limited to benchmark interest rates described in paragraph 815-20-25-6A.<sup>8</sup>

**815-50-15-2(f)** The notional amount of the swap ~~is equal to or less than the principal amount of the borrowing~~ matches the principal amount of the borrowing being hedged. In complying with this condition, the amount of the borrowing being hedged may be less than the total principal amount of the borrowing.

**PCC Question #2: Does the PCC agree with the conforming edits detailed above for the criteria in paragraphs 815-50-15-2(a) and 15-2(f)?**

*Management Intent*

22. The Original Proposal asked constituents whether the combined instruments approach should include a requirement regarding management's intent to hold the swap to maturity (unless the borrowing is prepaid). Some constituents opposed additional criteria about management's intent because they believe that such criteria would add little value as it is already implied by meeting the criteria to qualify for the combined instruments approach. Also, the respondents mentioned that such criteria would be an easy hurdle to overcome because management can always say that its original intent was to hold the swap to maturity. Other respondents noted that additional criteria related to management intent would only cause confusion because it is difficult to distinguish between management not having the original intent to hold the swap to maturity and management reacting to actual or perceived economic events. Thus, such criteria would be difficult to operationalize from an audit perspective and would be inconsistent with the simplification that the PCC is trying to achieve.

---

<sup>8</sup> Refer to paragraph 14 in Issue Summary No. 1, dated May 7, 2013, for a discussion of non-benchmark interest rates. Also, refer to paragraph BC 10 of Update 2014-03 for a discussion of the PCC's consideration of non-benchmark interest rates with respect to the simplified hedge accounting approach.

23. Other constituents noted that adding a requirement regarding management’s intent to hold the swap until maturity would be consistent with the principles of the combined instruments approach because the approach records the swap and variable-rate borrowing as a single synthetic fixed-rate borrowing. If the swap is settled before maturity, there would be a gain or loss on the settlement and the borrowing would revert from a fixed to a variable interest rate, which may be confusing to users of private company financial statements. Therefore, requiring management to state its intent to hold the swap to maturity would limit the ability of any entity to inappropriately elect this approach. Others suggested that any criteria regarding management intent would also need to address the notion of “tainting” (for example, similar to guidance in Section 320-10-35) if management subsequently terminates a swap accounted for under the combined instruments approach.

24. The staff considered two alternatives for adding a requirement to the combined instruments approach criteria regarding management intent. Specifically, the staff considered the following alternative views:

***View A—Include a requirement regarding management’s intent***

The PCC should include an up-front requirement regarding management’s intent to hold the swap to maturity (unless the borrowing is prepaid). Proponents of View A note that, because the combined instruments approach is a scope exception to the current derivatives and hedging guidance, strict criteria should have to be met to demonstrate that the swap was entered into for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing. Proponents of View A note that an up-front criterion regarding management intent would not be difficult to operationalize because management of the entity could consider pertinent historical experience, such as historical early terminations of similar swaps and the reasons for that action, in assessing whether the objective of entering into the swap for the purpose of economically obtaining a fixed-rate borrowing is met. Furthermore, proponents of View A note that incorporating management intent

would be consistent with guidance in Topic 815 regarding cash flow hedges of forecasted transactions.

***View B—Do not include a requirement regarding management’s intent***

The PCC should not include an up-front requirement regarding management’s intent to hold the swap to maturity. Proponents of View B note that the combined instruments approach requires an entity-wide accounting policy choice that would deter entities from applying the approach unless their intent was to hold the swap to maturity. Also, because the combined instruments approach is an entity-wide accounting policy election, Proponents of View B contend that an explicit up-front criterion regarding management intent would provide entities with optionality to change their assertion in order to avoid applying the combined instruments approach in certain circumstances. As such, an upfront criterion of management intent may nullify the decision to make the combined instruments approach an entity-wide accounting policy election. In addition, Proponents of View B note that a criterion regarding management intent would be difficult to operationalize because it is difficult to distinguish between management not having the original intent to hold the swap to maturity and management reacting to actual or perceived economic events.

**PCC Question #3: Does the PCC wish to reaffirm its decision to exclude management intent as a criterion (View B) for the combined instruments approach?**

*Adverse Developments/Credit Risk of the Counterparty*

25. The staff considered whether the combined instruments approach should include a requirement that there have been no adverse developments related to the risk of counterparty default such that the swap is not expected to be effective in economically converting a variable-rate borrowing into a fixed-rate borrowing. The staff notes that many swaps contain credit-risk-related contingent provisions. For example, if the private company were to fail to maintain its status as a well-capitalized entity, as that term may

be mutually defined, the counterparty to the swap could request immediate payment or demand immediate collateralization on swaps in net liability positions.

26. The staff notes that hedging strategies can only be effective if the derivative counterparty is expected to perform. Any subsequent adverse developments at the counterparty will call into question the basis for applying hedge accounting and the continuation of hedge accounting may no longer be acceptable. Therefore, some constituents believe that it may be appropriate to have a continuing assessment of adverse developments regarding the risk of counterparty default, similar to the current requirements under Topic 815 to qualify for hedge accounting.

27. Other constituents disagree with including a requirement that there have been no adverse developments regarding the risk of counterparty default because they believe that the costs of complying with that requirement would outweigh its benefits. Those constituents noted that many private entities do not have the resources to assess the credit quality of their counterparties in an effective manner. Furthermore, many constituents noted that this analysis is inherent in any audit or review engagement as part of the assessment of potential contingencies (that is, Topic 450). Therefore, an additional requirement would be unnecessary. Also, some constituents stated that the market for “plain vanilla” interest rate swaps is sufficiently well developed such that other parties are likely to assume counterparty swaps in the event of the insolvency of the counterparty.

28. The staff considered alternative viewpoints, such as whether an adverse development regarding counterparty default risk should result in the discontinuance of the combined instruments approach or, alternatively, results in additional disclosure. Specifically, the staff considered the following alternative views:

***View A—Discontinuance of the combined instruments approach***

Proponents of View A believe that instances in which it is probable that the swap counterparty will default on its payment obligations should result in the

discontinuance of “off balance sheet” treatment for the swap asset or liability and immediate recognition of the fair value of the swap asset or liability “on balance sheet” in accordance with the guidance in Topic 815. Proponents of this view believe that omitting the presentation of the swap asset or liability when a default of the swap counterparty is probable would result in inaccurately portraying the combined instrument as a fixed-rate borrowing at a point in time when the arrangement should be separated into a variable-rate borrowing along with a swap asset or liability.

***View B—Disclosure of counterparty default risk***

Proponents of View B believe that in instances in which the likelihood that the counterparty will not default ceases to be probable, the borrower should disclose that fact. In addition, the borrower should disclose that future income statement charges for interest expense may no longer approximate a fixed-rate borrowing. Proponents of View B believe that switching from “off balance sheet” treatment to “on balance sheet” treatment may result in practical challenges and confuse users of private company financial statements. Proponents of View B note that this would particularly be the case in instances in which the combined instruments approach results in “off balance sheet” treatment of an asset, which is generally the case when the borrower is in a favorable (gain) position with respect to the swap. For example, if a borrower was “kicked out” of the combined instruments approach, that would result in the borrower immediately recognizing a gain and an entry to record the “off balance sheet” asset “on the balance sheet.” Proponents of View B believe that recording the gain and related asset as the result of an adverse development in the counterparty’s credit rating would be counterintuitive and may confuse users. Proponents also believe that the proposed disclosures would better communicate the desired information to users of private company financial statements when compared to the alternative of recording the swap asset on the balance sheet.

**PCC Question #4: Does the PCC wish to reaffirm its previous decision to not have a requirement related to adverse developments regarding the risk of counterparty**

**default? If yes, should a disclosure for adverse developments regarding the risk of counterparty default be added (View B)?**

**PCC Question #5: After answering the questions above, does the PCC wish to reaffirm its previous decisions regarding the remaining criteria in paragraph 815-50-15-2?**

Disclosure

29. The Original Proposal contains the following disclosure items for the combined instruments approach:

- a. The settlement value of the swap (along with the valuation method and assumptions)
- b. The principal amount of the borrowing for which the forecasted interest payments have been swapped to a fixed rate and the remaining principal amount of the borrowing that has not been swapped to a fixed rate
- c. The location and amount of the gains and losses reported in the statement of financial performance arising from early termination, if any, of the swap
- d. The nature and existence of credit-risk-related contingent features and the circumstances in which the features could be triggered in a swap that is in a loss position at the end of the reporting period.

30. Most constituents who supported the combined instruments approach also supported the disclosure items listed above. Some constituents suggest removing the requirement to disclose “valuation methods and assumptions” utilized to determine settlement value. Those respondents noted that in situations in which settlement value is obtained directly from the swap counterparty, the valuation method and assumptions may not be readily obtainable.

31. The staff believes that it is important to consider constituent concerns regarding the requirement to disclose “valuation methods and assumptions” utilized to determine

settlement value. Because settlement value is not strictly defined, the staff believes that it is important for users to understand the methodology used in determining that amount. However, the staff believes that quantitative disclosure of the inputs and estimates used in determining the settlement value amount may not be required. The staff believes that, if necessary, a qualitative disclosure of the valuation methods and assumptions would provide private company financial statement users with a sufficient basis for beginning a more detailed discussion. As such, the following amendments to paragraph 815-50-50-1(b) were identified (added text is underlined and deleted text is ~~struck out~~):

A qualitative and/or quantitative description of the ~~The~~ method(s) and significant assumptions used to estimate the settlement value of the swap and a description of the changes during the period, if any, in the method(s) and significant assumptions used to estimate that settlement value.

**PCC Question #6: Does the PCC want to revise the guidance in paragraph 815-50-50-1(b)?**

*Exemption from Fair Value of Financial Instruments Disclosures*

32. The Original Proposal addressed scope requirements contained in Topic 825 on financial instruments, which provides guidance on required disclosures about the fair value of financial instruments for assets and liabilities that are not measured at fair value in the statement of financial position for which it is practicable to estimate fair value. In accordance with paragraph 825-10-50-3,<sup>9</sup> nonpublic entities that do not hold derivatives are exempt from Topic 825 fair value disclosures if certain conditions are met. For the purpose of evaluating whether Topic 825 disclosures are required, a swap recorded under the combined instruments approach is not considered a derivative instrument under Topic 815. As such, the combined instruments approach extends the exemption from certain fair value disclosures to private companies for which such swaps are their only derivatives.

---

<sup>9</sup> In accordance with paragraph 825-10-50-3, entities are exempt from Topic 825 fair value disclosures only if all of the following conditions are met:

- a. The entity is a nonpublic entity.
- b. The entity's total assets are less than \$100 million on the date of the financial statements.
- c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under Topic 815 other than commitments related to the origination of mortgage loans to be held for sale during the reporting period.

The staff notes that this exemption was also included in the final Update for the simplified hedge accounting.

**PCC Question #7: Does the PCC wish to reaffirm its previous decision regarding the exemption from Topic 825 fair value of financial instruments disclosures?**

Transition

*Accounting Policy Election and Election upon Adoption*

33. The staff believes that if the combined instruments approach is elected, it should be applied consistently for all qualifying swaps. Without such consistent application, the unique presentation guidelines of the approach may confuse users when entities choose whether to apply the approach to some instruments but not others. Therefore, the staff believes that the combined instruments approach should be applied as an entity-wide accounting policy election and should be applicable for all qualifying swaps. The staff also believes that the entity-wide accounting policy election to apply the combined instruments approach must be made upon adoption.

34. For entities that do not have existing eligible swaps, however, the staff notes the following guidance contained in the Original Proposal may be problematic for some private companies:

The election should be made upon adoption of the amendments in this proposed Update or, for entities that do not have existing eligible swaps, within a few weeks after the entity enters into its first transaction that is eligible for the accounting policy election.

35. The staff believes that it is important to consider constituent concerns that “within a few weeks” after the entity enters into its first transaction may not provide sufficient time for many private companies to assess the appropriate entity-wide accounting policy election. Those constituents noted that many private companies only evaluate accounting policies once a year in connection with preparing for a year-end audit or review. Further, the “within a few weeks” requirement may preclude combined instruments approach

accounting for many private companies that would otherwise benefit from the application. As such, the staff believes that private companies that do not have existing eligible swaps on the date that the combined instruments approach is effective should be provided with additional relief. Specifically, the following revisions to the guidance in the Original Proposal were identified (added text is underlined and deleted text is ~~struck out~~):

The election should be made upon adoption of the amendments in this proposed Update or, for entities that do not have existing eligible swaps, prior to the date that the financial statements are available to be issued for the period during which the entity enters into its first transaction that is eligible for the accounting policy election.

**PCC Question #8: Does the PCC want to revise the guidance for entities that do not have existing eligible swaps upon the effective date of this accounting alternative?**

*Modified and/or Full Retrospective Approach*

36. The staff notes that the accounting alternative would be provided with an option to apply the amendments using either (a) the modified retrospective approach or (b) the full retrospective approach. The staff notes that, unlike public companies, there are no specific requirements for private companies to present comparative information. The staff notes that it is preferable to provide greater flexibility in the application of a retrospective approach given the various presentation alternatives available to private companies (for example, one-year presentation). Furthermore, the option to apply either the modified approach or the full retrospective approach would allow entities to apply the full retrospective approach when such approach is deemed preferable, while providing other entities with a more cost-effective alternative (that is, modified retrospective approach) when full retrospective application would be overly burdensome.

**PCC Question #9: Does the PCC wish to reaffirm its previous decision to allow an option to apply either the modified approach or the full retrospective transition approach?**

*Effective Date and Early Adoption*

37. The staff notes that private companies would be able to apply the alternative, if elected, to swaps existing as of the beginning of the period of adoption and for swaps entered into during annual periods beginning after December 15, 2014, and interim periods within annual periods after December 15, 2015, and that early application should be permitted. The staff notes that making the guidance effective in 2015 (for calendar year companies) acknowledges the fact that private companies and their auditors often do not learn about new guidance until later in the year and that the final standard may be issued while their resources are focused on year-end close and other matters.

**PCC Question #10: Does the PCC agree that the effective date is appropriate?**

**Board Meeting Handout**  
**Pre-Agenda Research Project—Post Implementation Review (PIR) of**  
**Operating Segments**  
**January 22, 2014**

**Purpose of This Meeting**

1. The purpose of this meeting is to discuss the agenda request for a potential future technical project following the evaluation of the findings from the Financial Accounting Foundation's (FAF) Post Implementation Review (PIR) Report on FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (Report), and that of the IASB's Report and Feedback Statement, Post-implementation Review: IFRS 8, *Operating Segments* (Feedback Statement).
2. The purpose of this meeting is to:
  - (a) Discuss those areas of Topic 280 that could be amended in response to both sets of PIR findings;
  - (b) Recommend whether a particular area should be included within the scope of the potential project;
  - (c) Consider the staff's proposed alternative solutions.

**Post Implementation Review (PIR) of Operating Segments Findings**

3. Statement 131, codified in Topic 280, and IFRS 8 are substantially converged standards (Standards). Accordingly, the staff has analyzed the findings from both the Feedback Statement and the Report when considering those areas of the Standards that could be amended in response to the PIR findings.
4. The staff interprets both the Feedback Statement and the Report as concluding that, overall, Statement 131 has achieved the objectives that the Board intended when it was issued and it has improved financial reporting. Both PIRs indicate that the Standards are, in general, working effectively and that more information about an entity's business activities is provided. The Standards have generally enhanced the relevance of segment

---

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

reporting and promote greater alignment between the financial statements, management commentary and analyst presentations.

5. Accordingly, the staff believes that the PIRs do not call for a reconsideration of the core principle on which the Standards are based—the management approach. The staff believes, however, that some issues identified in the PIRs could be considered for potential improvement and the nature of any future FASB project would be limited in scope.

## **Potential Project Scope**

6. Certain findings, such as determining the level of discrete reports used to identify segments, are interconnected with other parts of the Standards. The staff has considered not just the PIR findings, but also the interconnected areas of the standard that may be affected by making potential improvements. That means that certain issues not raised by the PIRs are including within the staff’s analysis and recommendation. The staff believes that this provides a more comprehensive description of the project’s potential scope. Our analysis indicates that the PIRs findings and interconnected areas focus on eight potential areas of the Standards:

***a. Segment identification:***

- (1) Identification of the Chief Operating Decision Maker (CODM)
- (2) Determining the operating segments from discrete reports
- (3) Interaction with the segment manager guidance

***b. Aggregation criteria:***

- (4) Aggregation criteria

***c. Disclosure requirements:***

- (5) Disclosure package
- (6) Different measures of segment profit

***d. Reconciliations:***

- (7) Reconciliation of segment information to consolidated totals
- (8) Allocation of reconciling items to individual segments

7. These eight areas fall naturally under four themes, being segment identification, aggregation criteria, disclosures and reconciliations. From the U.S perspective, the staff’s

outreach confirms that there are three key areas that stakeholders would consider for improvement.

### ***Segment identification***

8. IFRS stakeholders would like further clarification and improvement to the description of the CODM function to assist in the identification of that role (Issue 1). While this was not a significant finding in the Report, the staff has recommended that any potential FASB project should include this issue due to its overall significance in determining the operating segments.
9. U.S. stakeholders would like additional guidance to assist in discerning the level of discrete reports or data sets that are to be used for segment identification (Issue 2). In response, the staff has recommended that any potential FASB project should include this issue and has suggested that the Board could develop “principle and indicators” for determining this level.
10. The guidance on segment managers (Issue 3) is interconnected with the previous issue on discrete reports. While there may be no changes proposed to this part of Standard, the staff believes that any potential improvements in Issue 2 should be reviewed for consistency with the segment manager guidance.

### ***Aggregation criteria***

11. U.S. stakeholders would like additional guidance on when segments can be aggregated and the nature of the ‘similar economic characteristics’ criteria (Issue 4). The staff’s outreach indicates that one interpretation of the standard is that this criterion is a quantitative test, however, alternate interpretations suggest that it is broader in nature and may include other characteristics. The staff has recommended that any potential FASB project should include this issue and that the Board could clarify the nature of the ‘similar economic characteristics’ test.

### ***Disclosure requirements***

12. U.S. investors would like the Board to require certain disclosures by segment including gross margin, operating cash flow and working capital (Issue 5). The staff was advised

during its outreach that these line items, in particular, are useful for financial statement analysis. In response, the staff has recommended that the Board re-visit the disclosure package in Topic 280 as part of this potential project.

13. A number of U.S. investors also indicated that comparability is important when analyzing segment information and would like to see greater consistency in segment line items across companies, such as segment profit or loss (Issue 6). In response, the staff has recommended that any potential FASB project includes this issue and that the Board could consider different ways and measures of disclosing the segment results.

### ***Reconciliations***

14. Unlike the IASB, the FASB staff did not hear significant concerns from U.S. stakeholders about the presentation of segment reconciliations (Issue 7) or the allocation of reconciling items to individual segments (Issue 8). Accordingly, the staff has not recommended those PIR findings form part of the FASB's potential project scope.

### ***Staff Recommended Scope for the Potential FASB project***

15. For the purposes of recommending the potential scope of this project, the FASB staff believes that items (1)-(6) from the above list should be included. This recommendation includes the three key issues raised by U.S. stakeholders together with their interconnected areas.

### **Convergence considerations**

16. Both the IASB and the FASB have expressed a desire to stay substantially converged on segment reporting. In that regard, the staff seeks to balance convergence objectives while responding to U.S stakeholder's feedback. Agreeing on a suitable working approach with the IASB, where the project scope overlaps, will be key to maintaining convergence and will be a constructive way to cooperate on this potential project.

### Questions for the Board

1. Would the Board like to add a limited-scope project on operating segments to the technical agenda?
2. If so, does the Board agree with the staff's recommended scope?

**Board Meeting Handout  
Pensions and Other Postretirement Benefit Plans  
January 22, 2014**

**Purpose of This Meeting**

1. The purpose of this meeting is to discuss whether there are technically feasible, cost beneficial alternatives to addressing the issues with measuring an employer's obligation for defined benefit plans, including cash balance plans. It is a continuation of the staff's pre-agenda research on the pervasive issues with the accounting for pensions and other postretirement benefit plans, and whether there are technically feasible, cost-beneficial alternatives to addressing those issues.

**Background**

2. At education sessions on June 26, 2013, and September 4, 2013, the staff discussed issues with measuring an employer's obligation for defined benefit plans. Those meetings focused on issues with the discount rate used to measuring the present value of the defined benefit obligation and the accounting for cash balance pension plans. After the September 4, 2013 meeting, the FASB received two unsolicited comment letters on pensions and other postretirement benefit plans, much of which focus on the issue of measuring the present value of an employer's defined benefit obligation.
3. After the feedback received in those meetings and comment letters, the staff decided to perform further research and analysis of whether there are technically feasible, cost beneficial alternatives to addressing issues with measuring an employer's defined benefit obligation, including cash balance plans.

---

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

### ***Review of Feedback from Stakeholders***

4. The feedback from stakeholders has been diverse about both the pervasiveness of the issues and recommendations for solutions. Almost all users did not cite measurement as a pervasive issue with the accounting for defined benefit pension and other postretirement benefit plans. Rather, users raised significant concerns about the issue of the lack of comparability among entities that use diverse methods for recognizing actuarial gains and losses in the income statement and other comprehensive income.
5. However, several preparers, actuaries, and auditors noted that there is a pervasive issue with measuring an employer's defined benefit obligation. Some noted that the guidance on selecting an assumed discount rate overstates pension and other postretirement benefit obligations because of the current low interest rates in comparison with historical norms. Those stakeholders stated that a different discount rate should be used to measure the present value of an employer's defined benefit postretirement benefit obligation. For example, some of those preparers recommend that it should be based on the expected return on plan assets because those assets will be used to pay the benefit obligation over time.
6. Others recommend using an average historical bond rate instead of the most recent current bond rate. They note that the defined benefit obligation is long term in nature and benefit payments are paid out over a long period of time. Therefore, they question the relevance of remeasuring the defined benefit obligation using a discount rate as of the date of the statement of financial position.
7. Several auditors and actuaries noted that the guidance could be improved so that there is more consistent application of selecting a discount rate at which the defined benefit obligation could be effectively settled. They note that preparers have moved away from using bond indexes and, instead, are using yield curves in determining their discount rates. Because the guidance does not require a consistent methodology, preparers can pick and choose among the different methodologies, which leads to inconsistency in practice and reduces comparability among entities.

## **Alternatives for a Narrow Project on Measuring Cash Balance Plans**

### **Scope**

8. The first issue with adding a project to address the measurement of cash balance plans would be defining its scope. A typical cash balance pension plan communicates the benefit earned in terms of a cash balance. Typically, the cash balance grows as a result of service and interest credits. However, other arrangements may be similar, including traditional annuity plans that offer a lump sum payout option at retirement and retiree healthcare plans that measure and define the benefit in terms of a cash balance.

### ***Issues with the Walk Away Amount Alternative***

9. One alternative that was explored by the Board when it tried to address issues with measuring cash balance plans in 2004 was the walk away amount. This amount represents an employee's notional account balance that they would be entitled to if they left the employer and elected a lump sum distribution rather than remaining in the plan.
10. The staff thinks that using the walk away amount does not faithfully represent an employer's obligation for a cash balance plan. First, it is a measurement based on the assumption that all employees will leave the entity on the measurement date and elect a lump sum distribution. Presently, employers with traditional plans that include a lump sum option include projections of employees that are expected to select the lump sum option rather than an annuity.
11. Second, it fails to distinguish between cash balance plans that have very different promises. For example, a plan that promises a fixed interest crediting rate of 3 percent is very different from one that promises 3 percent for the first 5 years and 5 percent until retirement. Under a walk away measurement, those plans would have the same obligation for the first 5 years.
12. Additionally, using the walk away amount would introduce a separate measurement model for cash balance plans that would raise questions about inconsistencies with the accounting for traditional plans. For example, in a traditional plan the projected

benefit obligation includes amounts related to presently unvested benefits, even though the walk away amount for those benefits would be zero. Also, some stakeholders might take the position that reflecting future increases in pay for pay-related plans is inconsistent with the notion of a present obligation.

### **Alternatives for a Comprehensive Project on Measuring All Defined Benefit Plans**

13. The staff believes that the problems with measuring an employer's defined benefit obligation are due to the effective-settlement method that is required for measuring the present value of the defined benefit obligation. The limited guidance on applying that method to an obligation that in many cases cannot be "effectively settled" has led to diversity in practice.
14. Other measurement methods could be explored for measuring the present value of defined benefit obligations. However, a project that fundamentally reconsiders measurement would entail high costs in terms of time, complexity, and resources as evidenced by past projects that have reconsidered measurement. The measurement methods in ongoing projects on leases, insurance, and financial instruments are all different. Additionally, stakeholders' views on how and whether measurement of an employer's defined benefit obligation should be improved are diverse.
15. Due to the diverse measurement methods used in current U.S. GAAP and recent exposure drafts, and the diversity of views on potential alternatives, the staff believes that there is no clearly identifiable alternative that is cost-beneficial for addressing any current issues with measuring an employer's obligation for defined benefit plans at this time.