

Board Meeting Handout
Accounting for Financial Instruments: Hedging
February 15, 2017

PURPOSE OF THIS MEETING

1. The purpose of this decision-making Board meeting is to discuss the following issues for redeliberation:
 - (a) **Issue 1:** Returning to qualitative assessments of hedge effectiveness after performing a quantitative assessment of hedge effectiveness
 - (b) **Issue 2:** Potential changes to the requirements for private company hedge documentation.

ISSUE 1: RETURNING TO QUALITATIVE ASSESSMENTS OF HEDGE EFFECTIVENESS AFTER PERFORMING A QUANTITATIVE ASSESSMENT OF HEDGE EFFECTIVENESS

Overview

2. The proposed Update would permit an entity to elect at hedge inception to perform subsequent assessments of effectiveness qualitatively after an initial quantitative test. The proposed Update would prohibit a return to qualitative testing in subsequent periods after an entity determines that a quantitative assessment of effectiveness is required because of a change in facts and circumstances. At the January 25, 2017 meeting, the Board decided to redeliberate this issue.

Alternatives

3. There are two alternatives for consideration:
 - (a) **Alternative A:** Affirm the Board's decision that an entity should be permitted to return to qualitative assessments of hedge effectiveness after a quantitative assessment.

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- (b) **Alternative B:** Allow an entity to return to qualitative testing after a quantitative assessment.
4. If Alternative B is selected, an additional question is whether the same principle and factors should be used to evaluate the appropriateness of a return to qualitative testing as those used to evaluate qualitative testing at hedge inception.

Questions 1 and 2 for the Board

1. Does the Board believe an entity should be permitted to return to qualitative assessments of hedge effectiveness after a change in facts and circumstances requires a quantitative assessment to be performed or the entity elects to perform a quantitative assessment to validate whether qualitative assessments of hedge effectiveness remain appropriate?
2. If the Board believes an entity should be able to return to qualitative assessments of hedge effectiveness, does the Board believe that the same principle and factors should be used to evaluate whether or not an entity could perform qualitative assessments both (a) at hedge inception and (b) after a quantitative test has been performed after hedge inception?

TOPIC 2: POTENTIAL CHANGES TO THE REQUIREMENTS FOR PRIVATE COMPANY HEDGE DOCUMENTATION

Overview

5. The proposed amendments on the timing of the preparation of hedge documentation and subsequent qualitative testing would apply to both public business entities and private companies. Private company stakeholders maintain that additional relief in the timing and content of hedge documentation should be provided for private companies. At the January 25 Board meeting, the Board decided to redeliberate the timing of the preparation of hedge documentation for private companies and instructed the staff to identify possible alternatives.

Alternatives

6. The following are the potential alternatives:

- (a) **Alternative A:** Allow a private company to complete all initial and subsequent hedge documentation before annual financial statements are available to be issued. No documentation would be required at hedge inception. The private company must prepare all initial hedge documentation and perform initial and/or subsequent effectiveness testing before interim financial statements are available to be issued if it issues interim financial statements.
- (b) **Alternative B:** Allow a private company to prepare a “statement of intent to hedge” at hedge inception. All other initial and subsequent hedge effectiveness testing (either on a quantitative or qualitative basis as permitted or required by Topic 815, Derivatives and Hedging) would not be required until financial statements are available to be issued. The private company must perform initial and/or subsequent hedge effectiveness testing before interim financial statements are available to be issued if it issues interim financial statements. The statement of intent to hedge would include the following information in accordance with paragraph 815-20-25-3(b)(2):
- (i) The hedging instrument
 - (ii) The hedged item or transaction¹
 - (iii) The nature of the risk being hedged
 - (iv) The method that will be used to assess effectiveness both at hedge inception and subsequently.
- (c) **Alternative C:** Allow a private company the same relief as that provided for public business entities. This would retain the amendments in the proposed Update with no additional relief for private companies.

7. The staff also will ask the Board, if it decides to provide incremental relief to private companies, whether it believes this relief should be extended to private companies that are financial institutions.

¹ A description of the hedged item would include the requirements of paragraph 815-20-25-3(c) or 25-3(d) related to documentation applicable to fair value or cash flow hedges only.

Questions 3 and 4 for the Board

3. Does the Board believe private companies should have additional relief as it relates to the timing or content of hedge documentation? If so, which alternative does the Board prefer?
4. If the Board decides to provide incremental relief for private companies, does the Board believe that financial institutions that are private companies should be included within the scope of this relief?

Board Meeting Handout
Revenue Recognition—Research
February 15, 2017

PURPOSE OF THIS MEETING

1. The purpose of this Board meeting is to discuss outreach and research that the staff has performed on the accounting for nonrecurring engineering and preproduction costs and the related reimbursements from customers.
2. At its October 19, 2016 Board meeting on technical corrections and improvements to Topic 606, Revenue from Contracts with Customers, the Board decided to remove amendments to the guidance in Subtopic 340-10, Other Assets and Deferred Costs—Overall, on preproduction costs related to long-term supply arrangements from the scope of that project (that is, not supersede Subtopic 340-10). When removing those amendments from the project’s scope, the Board requested that the staff perform additional research and outreach on the issues.

BACKGROUND

3. In January 2017, the FASB staff held an outreach meeting that included preparers from the automotive supply, aerospace and defense, and power and utilities industries as well as representatives from several audit and accounting consulting firms. This outreach meeting was held in response the Board asking the staff at the October 2016 Board meeting to perform additional research on accounting for preproduction costs.
4. The following two questions were the focus of the discussion of the outreach meeting.
 - (a) Issue 1: What guidance should be applied upon the adoption of the new revenue standard to determine whether nonrecurring engineering and pre-production costs should be capitalized or expensed?

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- (b) Issue 2: Should customer reimbursements be presented as revenue or contra-expense?
5. The following are some examples of fact patterns provided by stakeholders for which those questions are relevant:
- (a) Automotive suppliers generally contract with their customers, original equipment manufacturers (OEMs), to supply specific parts for the duration of production of a specific vehicle model, generally ranging from 3 to 10 years. Preproduction activities are undertaken, including engineering design and development, prototypes, and tooling, to produce those parts (and fulfill the contract).
 - (b) Suppliers in the commercial aerospace industry often contract with airframe OEMs to produce specialized equipment and systems for a particular airframe over an extended time period. Commercial aerospace suppliers generally make significant preproduction investments to develop the unique capabilities required to meet the detailed OEM specifications described in the contract. A wide range of activities may be required during the engineering phase of a commercial aerospace contract, which may include development of hardware, software, and interfaces to other aircraft systems, among others. Nonrecurring engineering also typically includes costs associated with project management, customer support, safety and reliability, quality, testing, and tooling.
 - (c) In the power and utility industry, customer reimbursements for contributions in aid of construction (CIAC) is money contributed to a regulated utility from a customer for the construction of assets that allow the customer to obtain the utility service. For example, if a customer's home is far from the road where the utility line or gas line is located, the entity requires the customer to pay a portion of the cost of constructing the assets (utility poles and lines or gas line) necessary for the customer to be able to receive services. The portion

of the construction costs paid by the entity and the customer is set by regulation. CIAC is contributed by a future customer that requests an uneconomic connection based on projected consumption and regulator-established utility rates. CIAC is paid up front and covers the uneconomic portion of the utility's investment on a dollar-for-dollar basis (no margin for the utility), as determined by the regulator.

6. In November 2016, the Board added a project to its technical agenda on collaborative arrangements. A collaborative arrangement is a contractual arrangement that involves joint operating activity and involves two parties that both are active participants in the activity and are exposed to significant risks and rewards dependent on the commercial success of the activity. The collaborative arrangements project is aimed at making targeted improvements to clarify when transactions between partners in a collaborative arrangement are within the scope of the revenue guidance in Topic 606. The staff thinks there is potential that some nonrecurring engineering/preproduction arrangements might meet the definition of a collaborative arrangement. In addition, the question about whether customer reimbursements should be presented as revenue or contra-expense is similar to questions raised in the FASB's ongoing project about collaborative arrangements regarding payments between participants in the arrangement.

Issue 1: What guidance should be applied upon the adoption of the new revenue standard to determine whether nonrecurring engineering and preproduction costs should be capitalized or expensed?

7. Upon adoption of the new revenue standard (the amendments in Update 2014-09), the following cost guidance is applicable:
 - (a) Subtopic 340-10, Other Assets and Deferred Costs—Overall: Preproduction costs are expensed as incurred unless a contractual guarantee for reimbursement from the customer exists. Design and development costs for molds, dies, and other tools that a supplier will not own and that will be used in producing the products under the long-term supply arrangement are capitalized if the supply arrangement provides the

supplier the noncancellable right to use the molds, dies, and other tools during the supply arrangement. This guidance was not superseded and remains GAAP.

- (b) Subtopic 340-40, Other Assets and Deferred Costs—Contracts with Customers: The Board issued cost guidance in Subtopic 340-40 at the same time it issued Topic 606. The guidance on costs to fulfill a contract in Subtopic 340-40 requires an entity to recognize an asset from the costs to fulfill a contract if those costs meets certain criteria. The scope in paragraph 340-40-15-3 explains that this guidance applies to costs incurred in fulfilling a contract with a customer within the scope of Topic 606 unless the costs are within the scope of another Topic or Subtopic.
 - (c) Topic 730, Research and Development: Research and development is expensed as incurred. The guidance does not apply to accounting for the costs of research and development activities conducted for others under a contractual arrangement. This guidance was not superseded and remains GAAP.
8. Guidance on precontract costs in Subtopic 605-35, Revenue Recognition—Construction-Type and Production-Type Contracts, was superseded by Update 2014-09 and, therefore, no longer will be GAAP following the adoption of Update 2014-09. That guidance required precontract costs to be deferred when they were incurred in anticipation of a specific contract that would result in no future benefit unless the contract was obtained (such as the costs of mobilization, engineering, architectural, or other services incurred on the basis of commitments or other indications of interest in negotiating a contract).
9. The majority of the discussion on the cost capitalization guidance at the outreach meeting was about the scope of the guidance in Subtopic 340-40 and the interaction with the scope of the guidance in Subtopic 340-10. In particular, the following two concerns were raised:

- (a) The cost guidance in Subtopic 340-40 is applicable only if the costs are not within the scope of other cost guidance (that is, it is applied to a residual set of transactions). However, meeting participants noted that entities must be applying other accounting guidance today to those transactions and, thus, the residual nature of the scope might be unclear in some cases. Additionally, entities' cost accounting practices have developed over time and they may not know if they squarely fit within the guidance of Subtopic 340-10 or if they are applying the guidance by analogy in the absence of GAAP for their specific fact patterns. For example, if an entity capitalizes costs when it has a reimbursement from a customer, does that automatically mean that it is applying the guidance in Subtopic 340-10? What cost guidance should it apply upon the adoption of Topic 606 if it is not within the scope of Subtopic 340-10, but apply it by analogy?
- (b) As originally discussed at the January 2016 Technical Corrections Board meeting, the staff thinks the scope of the guidance in Subtopic 340-10 is unclear to practice. The scope notes that it applies to "all entities" and "preproduction costs related to long-term supply arrangements." While this scope is drafted very broadly, the staff understands that it is applied narrowly in practice. The source of the guidance was EITF Issue No. 99-5, "Accounting for Pre-Production Costs Related to Long-Term Supply Arrangements," which did not include any detailed scoping guidance.

10. The following summarizes the staff's analysis on this issue.

- (a) The basis for conclusions in Update 2014-09 explains that the revenue project did not include a comprehensive cost project. Therefore, the issuance of Update 2014-09 is not expected to resolve all existing diversity in practice in cost accounting.
- (b) Stakeholders questioned the scope of the guidance in Subtopic 340-40, in part, because the scope guidance in Subtopic 340-10 and other areas of GAAP is unclear in practice for some fact patterns. Consequently, some stakeholders noted that they expect some diversity in which *model* is

applied given the practice questions that existed before the new revenue standard about the scope of the cost guidance.

- (c) The staff's view is that the scope guidance in Subtopic 340-40 is not intended to preclude entities from reassessing their historical accounting. For example, assume today an entity is applying Subtopic 340-10 or another area of GAAP by analogy because the scope of the guidance is unclear or no GAAP directly addresses the entity's transaction. The staff thinks it would be acceptable for that entity to evaluate the scope of Subtopic 340-40 and, if appropriate, apply Subtopic 340-40.
 - (d) The staff's view is that the guidance in Subtopic 340-40 does not require an entity to holistically reassess all of its historical cost capitalization practices. For example, many entities have made judgments today about which costs are eligible for capitalization, such as judgments about what constitutes direct and indirect contract costs in accordance with cost guidance in Subtopic 605-35. Today, different companies judge those questions in different, but reasonable ways. Similar judgments will be required in determining which costs constitute direct and indirect costs when complying with the cost capitalization guidance in Subtopic 340-40.
 - (e) The staff's view is that when an entity is evaluating its accounting for nonrecurring engineering and preproduction costs, it should consider disclosure requirements for the cost guidance that is applied; the disclosure requirements about accounting policies in Topic 235, Notes to Financial Statements; and other applicable disclosure requirements in GAAP.
11. The staff recommends that the Board continue to monitor implementation of the new revenue standard and, after entities have adopted the standard, assess whether there is diversity in practice that matters to investors that would warrant improvements to GAAP.

Issue 2: Should customer reimbursements be presented as revenue or contra-expense?

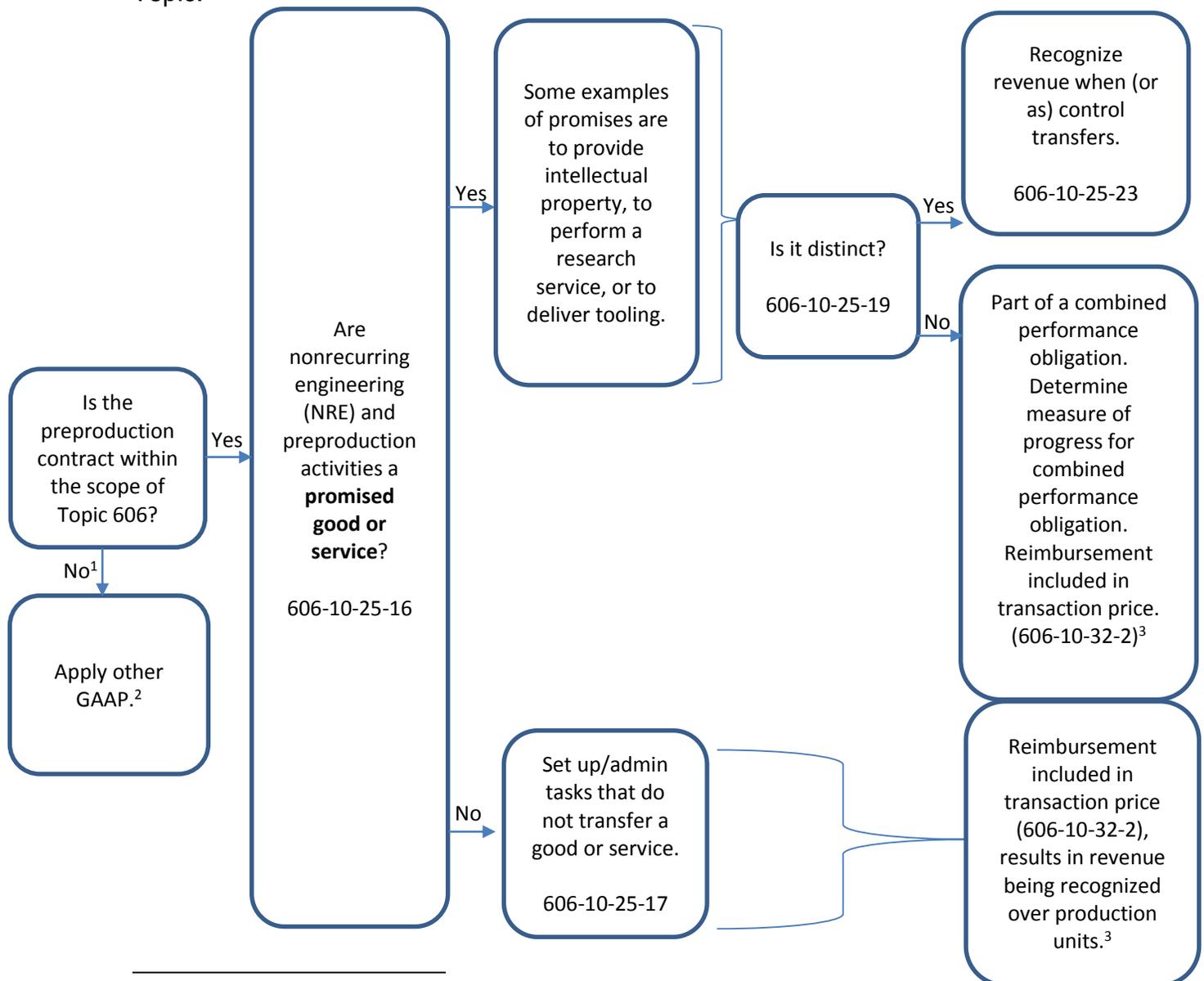
12. Under current GAAP, the staff understands that some entities conclude that the presentation of customer reimbursements is revenue or contra-expense (or other income) depending on whether they view the arrangements as within the scope of the revenue guidance and on the basis of their views of whether the nonrecurring engineering and preproduction is a deliverable in Topic 605, Revenue Recognition.
13. Upon adoption of the amendments in Update 2014-09, the accounting framework that will be applied to presentation of customer reimbursements, at a high level, is similar to current GAAP. First, entities will assess whether a transaction is within the scope of Topic 606. If the transaction is within the scope of Topic 606, then the entity will determine whether the activities are a performance obligation. To identify performance obligations, an entity will (a) identify promised goods or services in the contract with a customer and (b) determine whether those promises are distinct. See Appendix A for a flow chart of this assessment. This assessment will require judgment, but judgment in this area is not limited to transactions that include nonrecurring engineering and preproduction activities. The staff and members of the Transition Resource Group for Revenue Recognition commented that a preparer will need to apply judgment to reach conclusions about the overall nature of the promise to a customer and to identify the performance obligations.
14. At present, it is the staff's view that there is no accounting issue to resolve because a framework exists and many of the questions raised relate to the judgments required in applying that framework. Similar to the first issue in this handout, the staff recommends that the Board continue to monitor implementation of the new revenue standard.
15. The staff believes that when an entity is evaluating its accounting for reimbursements from customers for nonrecurring engineering and preproduction costs, it should consider the disclosure requirements for the cost guidance that is applied; the disclosures in Topic 606, if the payment is within the scope of Topic 606; the disclosure requirements about accounting policies in Topic 235; and other applicable disclosure requirements in GAAP.

Questions for the Board

1. Do Board members have any feedback about the issues described in this memo?
2. Is there any information Board members would like about the issues *before* the adoption of the new revenue standard?

Appendix A Topic 606 Flowchart

The following flow chart depicts the decision process for evaluating how to present reimbursements from customers. The flow chart does not include all of the guidance in Topic 606 and is not intended as a substitute for the guidance in that Topic.



¹ For example, the activities do not constitute an entity's ongoing major or central operations (Master Glossary – Revenue).

² This may result in the reimbursement being recorded as other income or as contra-expense.

³ If the NRE and the subsequent production units are in a single contract or the contracts meet the criteria for contract combination in paragraph 606-10-25-9, this may result in revenue being recognized over a period longer than the preproduction period. For example, it may result in revenue being recognized over subsequent production units.