## PRIVATE COMPANY COUNCIL

FASB Offices, 401 Merritt 7; Norwalk, Connecticut

## Public Meeting Agenda Day 1--Monday, July 15, 2013

**Day 2--Tuesday, July 16, 2013** 

Day 1Liaise with the Board			
4:15 – 4:35 pm (20 minutes)	Topic 3: Definition of a Nonpublic Entity  ➤ Update on tentative decisions (Gagnon)		
4:35 – 5:15 pm (40 minutes)	Topic 4: PCC Issues  ➤ Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements (formerly FIN 46(R) / FAS 167) (Cheng/Gupta)		
5:15 – 5:45 pm (30 minutes)	Topic 5: Private Company Decision Making Framework  ➤ Presentation of Comment Letter Summary (Cheng)		

Day 2Liaise with the Board, continued				
8:30 – 8:35 am	Introductory Remarks			
8:35 – 9:35 am (60 minutes)	Topic 1: Private Company Decision Making Framework  ➤ Any Necessary Revisions & Next Steps (Cheng)			
9:35 – 10:35 am (60 minutes)	Topic 2: PCC Preagenda Update  ➤ Development Stage Entities (Donoghue)			
10:35 – 10:50 am	BREAK (15 minutes)			
10:50 am – 12:20 pm (90 minutes)	Topic 3: PCC Issues  ➤ Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements (formerly FIN 46(R) / FAS 167) (Cheng/Gupta)			
12:20 – 1:20 pm	LUNCH (60 minutes)			
1:20 – 3:00 pm (100 minutes)	Topic 4: Selected FASB Projects – PCC discussion with FASB (Zimmerman/McKinney/Zeyher/Cappiello/Brown/Or)  ➤ Accounting for Financial Instruments - Update on Feedback  ➤ Leasing  ➤ Disclosure Framework – relationship with PCDMF and field testing  ➤ Government Assistance  ➤ Going Concern			
3:00 pm	ADJOURNMENT			

## **Private Company Council**

PCC Issue No. 13-02

Title: Applying Variable Interest Entity Guidance to Common Control Leasing

Arrangements

**Document:** Issue Summary No. 1\* (Revised)

PCC Meeting Date: July 15-16, 2013

FASB Staff: Michael Cheng / Rahul Gupta

PCC Liaisons: Neville Grusd, Lawrence Weinstock, Diane Rubin

**Dates previously discussed:** February 12, 2013, May 7, 2013

**Previously distributed PCC materials:** Agenda Request Issue No. 2, dated February 12, 2013

#### **Background**

1. At its February 12, 2013 meeting, the PCC voted to add a project to its agenda to address the application of variable interest entity guidance in related party leasing arrangements. After further outreach and research, the staff believes that a more appropriate project scope is leasing arrangements between private companies under common control (common control leasing arrangements). In common control leasing arrangements, the common owner has power over the operations and flow of resources of both entities in the related-party leasing arrangement.

2. The purpose of this memorandum is to discuss the issues associated with applying variable interest entity (VIE) guidance to leasing arrangements between private companies under common control and to get direction from the PCC on how to address those issues.

<sup>\*</sup> The alternative views presented in this Issue Summary 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.

## Implicit Variable Interest and Related-Party Leasing Arrangements

3. FASB Staff Position No. FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003)*, Consolidation of Variable Interest Entities, was issued in March 2005 (and is included as Appendix A). In an FASB staff memorandum (dated October 18, 2004) supporting FSP FIN 46(R)-5, the staff stated that:

There appears to be diversity in practice with respect to whether a party must consider whether an indirect implicit variable interest exists when applying the provisions of FIN 46(R). This issue is important since a party that concludes it holds no variable interest (implicit or explicit) in a VIE would not apply FIN 46(R).

4. The staff memorandum went on to explain that the guidance in FSP FIN 46(R)-5 (codified in paragraphs 810-10-25-48 through 25-54, and paragraphs 810-10-55-88 through 55-89) was intended to provide additional guidance for identifying implicit variable interest. FSP FIN 46(R)-5 provided the following example (excerpts), hereinafter referred to as the "FSP example," of an implicit variable interest:

One of the two owners of Manufacturing Entity is also the sole owner of Leasing Entity, which is a VIE. The owner of Leasing Entity provides a guarantee of Leasing Entity's debt as required by the lender. Leasing Entity owns no assets other than the manufacturing facility being leased to Manufacturing Entity. The lease, with market terms, contains no explicit guarantees of the residual value of the real estate or purchase options and is therefore not considered a variable interest under paragraph 810-10-55-39 (previously paragraph B24 of Interpretation 46(R)). The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Entity and Leasing Entity.

- ... For example, Manufacturing Entity would be considered to hold an implicit variable interest in Leasing Entity if Manufacturing Entity effectively guaranteed the owner's investment in Leasing Entity.
- ... Manufacturing Entity may be expected to make funds available to Leasing Entity to prevent the owner's guarantee of Leasing Entity's debt from being called on, or Manufacturing Entity may be expected to make funds available to the owner to fund all or a portion of the call on Leasing Entity's debt guarantee.
- ... Those facts and circumstances include, but are not limited to, whether there is an economic incentive for Manufacturing Entity to act as a guarantor or to make funds available, whether such actions have happened in similar situations in the

past, and whether Manufacturing Entity acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

- 5. The staff also stated in the memorandum that without the guidance in FSP FIN 46(R)-5, there would exist a great deal of opportunity to circumvent the application of FIN 46(R) by structuring a transaction to directly protect the interest holder in a VIE as opposed to the VIE itself. FSP FIN 46(R)-5 suggests that the Manufacturing Entity (Operating Entity) may in certain circumstances have an implicit guarantee on Leasing Entity's debt (that is, a variable interest in Leasing Entity). If Manufacturing Entity has an implicit variable interest (that is, a guarantee on the debt) and Leasing Entity is a VIE, then Manufacturing Entity and its owner as a related party group is generally considered to be the primary beneficiary.
- 6. However, only one party in a related party group can be the primary beneficiary. Paragraph 810-10-25-44, provided below, states that the party within the related party group that is most closely associated with the VIE is the primary beneficiary. When performing this assessment, constituents place more weight on criterion (b); "the relationship and significance of the activities of the variable interest entity to the various parties within the related party group." As a result of criterion (b), Manufacturing Entity is generally considered to be the primary beneficiary because the leasing activity primarily benefits Manufacturing Entity. As a result of the FSP example, many constituents assumed that similar leasing arrangements between entities under common control should always result in the manufacturing entity consolidating the lessor VIE entity.
  - **810-10-25-44** In situations in which a reporting entity concludes that neither it nor one of its related parties has the characteristics in paragraph 810-10-25-38A but, as a group, the reporting entity and its related parties (including the de facto agents described in the preceding paragraph) have those characteristics, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary. The determination of which party within the related party group is most closely associated with the VIE requires judgment and shall be based on an analysis of all relevant facts and circumstances, including all of the following:
    - a. The existence of a principal-agency relationship between parties within the related party group

- b. The relationship and significance of the activities of the VIE to the various parties within the related party group
- c. A party's exposure to the variability associated with the anticipated economic performance of the VIE
- d. The design of the VIE.

## **Scope**

7. The scope of View A described in this memorandum would apply to all business entities applying VIE guidance in Subtopic 810-10 except for public business entities<sup>1</sup>. The scope of View B and View C would apply to all entites applying the VIE guidance in Subtopic 810-10.

#### Feedback/Private Company Decision-Making Framework Analysis

- 8. The FASB staff evaluated VIE guidance in Subtopic 810-10 for common control leasing arrangements under the recognition and measurement module of the proposed Private Company Decision Making Framework (the Guide) to determine whether the consolidated financial statements of the lessee entity provide relevant information to its users at a reasonable cost. The staff notes that the Guide places more weight on the overall response to questions that address user relevance.
- 9. The *primary* users of private company financial statements (lenders) have stated that they do not find consolidating a related party leasing entity (lessor) with a manufacturing entity (lessee) to be useful. Most private company lenders believe that the consolidation of the lessor distorts the financial statements of the lessee. Those users often have to make adjustments to the lessee's financial statements for their analysis by requesting a "consolidating" schedule. Accordingly, the

<sup>&</sup>lt;sup>1</sup> The Board expects that the final definition of a public business entity would be added to the Master Glossary. The Board has tentatively decided that a public business entity would be defined as a business entity meeting any one of the following criteria:

a. It is required to file or furnish financial statements with the Securities and Exchange Commission.

b. It is required to file or furnish financial statements with a regulatory agency in preparation for the sale of securities or for purposes of issuing securities.

c. It has issued (or is a conduit bond obligor) for unrestricted securities that can be traded on an exchange or an over the-counter market.

d. Its securities are unrestricted, and it is required to provide U.S. GAAP financial statements to be made publicly available on a periodic basis pursuant to a legal or regulatory requirement.

FASB staff believes that VIE guidance for common control leasing arrangements does not provide user-relevant information.

- 10. Some private company users, such as sureties, find consolidation of the related-party lessor entity to be useful. However, sureties have expressed the most interest in the terms of the debt issued by the lessor; this is especially true when the performance of a bonded project relies on collateralized equipment or property held by the lessor. Sureties have also stated that robust disclosures or the lessor's summary financial statements could be sufficient in instances in which the related-party lessor entity is not consolidated. Some sureties also indicated they have access to management and the owners of private companies. Therefore, the FASB staff believes that robust disclosures in the lessee's financial statements about nonconsolidated related-party lessor entities would accommodate the information needs of sureties.
- 11. The FASB staff noted that VIE guidance for common control leasing arrangements would meet most of the cost and complexity criteria discussed in paragraph 1.6 of the Guide. In other words, the staff believes that VIE guidance for common control leasing arrangements is too costly and complex to implement.
- 12. Since the FASB staff believes that VIE guidance for common control leasing arrangements does not provide user-relevant information and is too costly and complex to apply, the staff believes that there is a sufficient basis to consider an alternative for applying VIE guidance to such arrangements within U.S. generally accepted accounting principles (GAAP).

Issue 1: Whether there are any alternatives that the PCC would support to address the concerns of private companies in applying variable interest entity guidance in common control leasing arrangements.

View A: The Practicability Exception. This alternative would provide a practicability exception that exempts private companies from applying VIE guidance to common control leasing arrangements when the reporting entity is leasing from a lessor entity that is under common

control and substantially all of the activities of the lessor entity consist of leasing or supporting leasing activities.

- 13. View A would exempt a nonpublic reporting entity from applying VIE guidance in Subtopic 810-10 when the reporting entity and the lessor entity are under common control and substantially all of the lessor entity's activities consist of leasing or supporting leasing activities. The staff believes that the decision to apply the practicability exception under View A should be an accounting policy election applicable to all of a reporting entity's leasing arrangements within the scope of this Issue rather than a decision to be applied piecemeal to individual arrangements.
- 14. Under that approach, more robust disclosures surrounding the lessor entity and its debt (if applicable) would be required. Note that explicit variable interest, such as a guarantee, would not preclude a reporting entity from applying this practicability exception. The following draft paragraphs would be added to the Codification to amend the scope of Subtopic 810-10:

**810-10-15-XX** A legal entity need not be evaluated by a nonpublic entity to determine whether the legal entity is a VIE under the requirements of the Variable Interest Entities Subsections if all of the following criteria are present:

- a. The nonpublic entity and the legal entity are under common control
- b. The nonpublic entity has a lease arrangement with the legal entity
- c. Substantially all of the legal entity's business activities consist of leasing or supporting leasing activities.

Paragraph 810-10-50-XX requires certain disclosures to be made by nonpublic entities subject to this practicability exception.

**810-10-50-XX** A nonpublic entity that does not apply the requirements or the Variable Interest Entities Subsections to one or more VIEs or potential VIEs because they met the criteria described in paragraph 810-10-15-XX, shall disclose all of the following information:

- a. The key terms of the leasing arrangements
- b. Current period rent expense charged by the "related-party lessor" as required in paragraph 840-20-50-1
- c. Future committed lease payments based on a lease agreement, if applicable, as required in paragraph 840-20-50-2(a)
- d. The amount of debt and/or significant liabilities of the related-party lessor

- e. The key terms of existing debt agreements of the related-party lessor (for example, amount of debt, interest rate, maturity, pledged collateral, and so forth)
- f. The key terms of explicit interest in the leasing entity.
- 15. The FASB staff stresses that this practicability exception only exempts a nonpublic entity from applying VIE guidance in certain circumstances. The practicability exception does not exempt a nonpublic entity from applying the voting interest or partnership model in Subtopic 810-10. Therefore, because of its direct equity interests in a lessor entity under common control, the nonpublic entity could be required to consolidate the lessor entity through application of the voting interest or partnership model. If no consolidation model applies, then the reporting entity would generally follow leasing guidance to account for the lease with the lessor entity.
- 16. Proponents of View A believe that it would remove the complexities involved in applying VIE guidance for preparers and practitioners while providing pertinent information to the users of private company financial statements (red-flag approach). This alternative could provide immediate relief to private companies, which many perceive to be long overdue. View A will likely reduce audit costs associated with common control leasing arrangements. Under this approach, the audit effort will likely focus on the leasing arrangement and debt held at the leasing company. Moreover, allowing private companies that hold explicit and implicit interests in the lessor entity to apply the practicability exception broadens the benefitting population. Several respondents during the staff's outreach stated that it is common for the lessee entity to hold explicit interest in the lessor entity, such as a debt guarantee or a long date extension contract. Proponents of View A also believe that a practicability exception creates fewer unintended consequences than creating implementation guidance to clarify VIE guidance for related parties.
- 17. Opponents of View A believe that providing a practicability exception for private companies within U.S GAAP creates inconsistency in recognition and measurement between private companies and public companies. Proponents of View A however state that because this issue exists primarily among private companies, comparability would not be significantly affected. Opponents of View A state that this practicability exception does not contemplate

certain leasing arrangements under common control for which consolidation could provide more user-relevant information. Germane to that concern is the ability for private companies to structure around consolidation through the application of this practicability exception. Opponents of View A also argue that it fails to sufficiently address the issue with VIE guidance. By providing a practicability exception to a narrow set of circumstances, VIE guidance may continue to result in consolidation of related-party entities that users do not find relevant. Those opponents believe in addressing VIE guidance in its totality.

View A and Impact on the FSP Example

18. If the PCC concludes on View A, the staff believes that the PCC should recommend removing the FSP example from paragraphs 810-10-55-88 through 55-89.

19. View A directly contradicts the FSP example because it exempts private companies with a fact pattern very similar to the FSP example from applying VIE guidance. The staff acknowledges that if the FSP example is removed, there will be no implementation guidance for implicit variable interests in the Codification. However, the staff believes that the FSP example currently does not provide any incremental value because it is ambiguous and rarely analogized to by public companies.

View B: Clarifying the Primary Beneficiary Assessment. This alternative would provide clarification on how to identify the primary beneficiary in a common control leasing example when some or all of the variable interest holders are related parties.

20. Although the staff informed the PCC at its May 6, 2013 education session that it did not believe an approach similar to this was technically feasible, subsequent outreach and research has helped the staff identify an alternative that is supported by the current VIE guidance in Subtopic 810-10.

21. Under View B, the PCC would recommend that the Board make the following changes to existing VIE guidance:

- a. Amend the FSP example in paragraphs 810-10-55-88 through 55-89
- b. Add implementation guidance using the amended FSP example to clarify how to identify the primary beneficiary.
- 22. View B takes a more holistic approach to clarifying the VIE guidance because it would require addressing each of the steps preceding the identification of the primary beneficiary, which is the last step in the VIE model before consolidation. The following is a draft of the paragraphs that would be amended/added to the Codification to clarify how to identify the primary beneficiary under Subtopic 810-10 (added text is <u>underlined</u> and deleted text is <u>struck</u> out):

## >> Example 4: Implicit Variable Interests

**810-10-55-87** This example illustrates the guidance in paragraphs 810-10-25-48 through 25-54.

810-10-55-88 One of the two owners The sole owner of Manufacturing Entity is also the sole owner of Leasing Entity, which is a VIE. The owner of Leasing Entity provides a guarantee of Leasing Entity's debt as required by the lender. Leasing Entity owns no assets other than the manufacturing facility being leased to Manufacturing Entity. The purpose for establishing Leasing Entity is to achieve certain tax and other benefits for the owner. The lease, with market terms, contains no explicit guarantees of the residual value of the real estate or purchase options and is therefore not considered a variable interest under paragraph 810-10-55-39. The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Entity and Leasing Entity. Leasing Entity has fixed-rate debt financed by a third-party lender. Interest on the fixed-rate debt is paid to the lender before any funds are available to the owner. The owner of Leasing Entity provides a guarantee of Leasing Entity's fixed-rate debt as required by the lender.

810-10-55-89 Manufacturing Entity should consider whether it holds an implicit variable interest in Leasing Entity. Although the lease agreement itself does not contain a contractual guarantee, Manufacturing Entity should consider whether it holds an implicit variable interest in Leasing Entity as a result of the leasing arrangement and the relationship between it and the owner of Leasing Entity. For example, Manufacturing Entity would be considered to hold an implicit variable interest in Leasing Entity if Manufacturing Entity effectively guaranteed the owner's investment in Leasing Entity. The guidance in paragraphs 810-10-25-48 through 25-54 shall be used only to evaluate whether a variable interest exists under the Variable Interest Entities Subsections and

shall not be used in the evaluation of lease classification in accordance with Topic 840. Paragraph 840-10-25-26 addresses leases between related parties. Manufacturing Entity may be expected to make funds available to Leasing Entity to prevent the owner's guarantee of Leasing Entity's debt from being called on, or Manufacturing Entity may be expected to make funds available to the owner to fund all or a portion of the call on Leasing Entity's debt guarantee. The determination as to whether Manufacturing Entity is effectively guaranteeing all or a portion of the owner's investment or would be expected to make funds available and, therefore, an implicit variable interest exists, shall take into consideration all the relevant facts and circumstances. Those facts and circumstances include, but are not limited to, whether there is an economic incentive for Manufacturing Entity to act as a guarantor or to make funds available, whether such actions have happened in similar situations in the past, and whether Manufacturing Entity acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

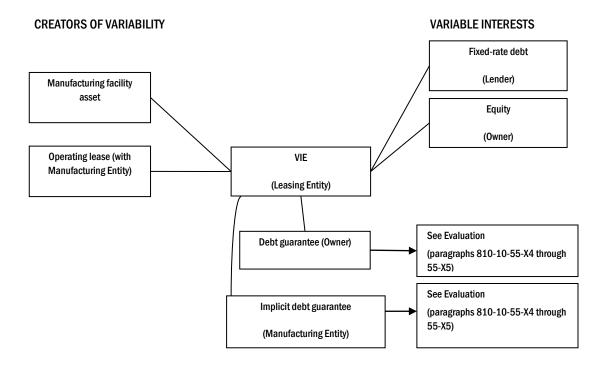
The staff is proposing that the following paragraphs be added to the Codification to clarify how to identify the primary beneficiary: [Note: The following paragraphs are not underlined for ease of readability.]

# >> Example 4A: Identifying the Primary Beneficiary in a Common Control Leasing Arrangement

**810-10-55-X1** This Example illustrates the guidance in paragraphs 810-10-25-21 through 25-36 related to determining the variability to be considered, in paragraphs 810-10-25-38A through 25-38G related to identifying the primary beneficiary, and in paragraphs 810-10-25-42 through 25-44 related to evaluating the effect of related parties.

**810-10-55-X2** For purposes of this example, assume the same facts as those provided in Example 4 and assume it is determined that Manufacturing Entity in Example 4 holds an implicit variable interest in Leasing Entity, which is considered to be a VIE.

**810-10-55-X3** The following diagram illustrates this situation.



## **810-10-55-X4** Leasing Entity is exposed to the following risks:

- a. Price risk with respect to changes in fair value of the underlying manufacturing facility asset
- b. Credit risk associated with possible default by Manufacturing Entity with respect to lease payments
- c. Risk with respect to possible changes in relevant tax or other law that may affect the tax and estate planning benefits associated with this structure.

**810-10-55-X5** The following factors should be considered in the determination of the purpose(s) for which Leasing Entity was created and in the determination of the variability Leasing Entity is designed to create and pass along to its interest holders:

- a. The primary purpose for which Leasing Entity was created was to provide the Owner with substantially all of the rights and obligations of direct ownership of the manufacturing facility, so that the Owner could obtain certain tax and other benefits through this structure.
- b. The fixed-rate debt was negotiated as an investment in a single-asset Leasing Entity, supported by the credit worthiness of the Owner.
- c. The Owner's debt guarantee effectively transfers substantially all of the credit risk associated with the lease and substantially all of the price risk associated with the property to the Owner.

d. Depending on the facts and circumstances, the Owner's obligation to absorb losses through its equity and through its debt guarantee could be mitigated by Manufacturing Entity's implicit guarantee of Leasing Entity's fixed-rate debt.

Based on this analysis, it can be determined that Leasing Entity was designed to create and pass along the risks in (a), (b), and (c) in the preceding paragraph to the Owner, the Lender, and the Manufacturing Entity, which are the Leasing Entity's variable interest holders.

**810-10-55-X6** When a reporting entity holds a variable interest in a VIE, the guidance in paragraph 810-10-25-38A requires the reporting entity to determine whether it individually has a controlling financial interest in the VIE and thus is the VIE's primary beneficiary. If the reporting entity concludes that neither it nor one of its related parties or de facto agents individually is the primary beneficiary, but, as a group, the reporting entity and its related parties and de facto agents have the characteristics of a primary beneficiary, then the guidance in paragraph 810-10-25-44 is applied to determine the party in the related party group that is most closely associated to the VIE and is therefore its primary beneficiary.

**810-10-55-X7** The Lender (through its fixed-rate loan), Manufacturing Entity (through its implicit guarantee of the loan), and the Owner (through its debt guarantee and through its equity) each have variable interests in Leasing Entity. Manufacturing Entity and the Owner are related parties. The rights of each of those parties would be considered individually when determining which party has the characteristics of a primary beneficiary. If no party individually has the characteristics of a primary beneficiary, then the Owner and Manufacturing Entity also may need to be evaluated as a group to determine whether the group has the characteristics of a controlling financial interest.

**810-10-55-X8** Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities.

**810-10-55-X9** The economic performance of Leasing Entity is significantly affected by changes in the fair value of the manufacturing facility, the overall legal and tax structure of this arrangement, and the credit of Manufacturing Entity.

**810-10-55-X10** The owner of Leasing Entity has the ability to remarket the manufacturing facility (if needed), to negotiate the tax and legal structuring of the Leasing Entity, and to establish the leasing terms. The Owner's ability to direct those activities comes through its equity interests in Leasing Entity (and not indirectly through its involvement with Manufacturing Entity). Each of those decisions would significantly affect the economic performance of Leasing Entity and would allow the Owner to increase the benefits it can receive and limit the losses it can suffer through its variable interests in Leasing Entity. Based on those considerations, the Owner is identified as the

party with the power to direct the activities that most significantly affect Leasing Entity's performance.

810-10-55-X11 Manufacturing Entity's day-to-day maintenance and operation of the manufacturing facility could have an effect on the facility's fair value and therefore could affect the economic performance of Leasing Entity. However, those activities likely would not significantly affect the manufacturing facility's fair value. Any decisions that significantly affect the fair value likely would be subject to the requirements of the leasing arrangement and would likely require the consent of one or more of the other variable interest holders. Such decisions would be outside of the purpose and design of the arrangement (for example, making significant leasehold improvements). Furthermore, Manufacturing Entity would not be able to make any other decisions that would significantly affect the economic performance of Leasing Entity. Therefore, Manufacturing Entity does not direct the activities that significantly affect the economic performance of Leasing Entity.

**810-10-55-X12** The Lender may hold protective rights (for example, through debt covenants). However, the Lender does not have the power to direct the activities that most significantly affect Leasing Entity's performance. Therefore, the Lender would not be identified as having power over the VIE.

810-10-55-X13 If a reporting entity has the power to direct the activities of a VIE that most significantly affect the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. As the sole owner of Leasing Entity, the Owner could absorb losses or receive benefits that are considered to be significant to Leasing Entity. Depending on the facts and circumstances, the Owner's obligation to absorb losses could be mitigated by Manufacturing Entity's implicit guarantee of Leasing Entity's fixed-rate debt. Nonetheless, the sole owner still would be entitled to receive benefits that could potentially be significant to the VIE. Therefore, the Owner would be deemed to have this characteristic of a primary beneficiary.

**810-10-55-X14** On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the Owner would be deemed to be the primary beneficiary of Leasing Entity because:

- a. It is the variable interest holder with the power to direct the activities of Leasing Entity that most significantly affects its economic performance.
- b. As the sole owner of Leasing Entity, it has the obligation to absorb losses or the right to receive benefits from Leasing Entity, either of which could potentially be significant to Leasing Entity.

**810-10-55-X15** Because the Owner meets the requirements to be the primary beneficiary individually, it is not necessary to apply the guidance in paragraph 810-10-25-44 to determine whether the manufacturing entity or the owner is most closely associated to Leasing Entity.

- 23. Proponents of View B proponents believe that this alternative does not change VIE guidance, instead, it provides clarity on identifying the primary beneficiary in situations commonly found in the private company sector. Many argue that the VIE disclosures are not considered to be burdensome in this situation because many private company constituents already provide related party disclosures that are similar to the VIE disclosures. Some proponents argue that the assessment of a leasing company would be very simple under View B. Those proponents stated that they would automatically assume that the leasing company is a VIE and disclose whatever is required without performing a comprehensive VIE assessment. By reinforcing and clarifying the principles of the VIE model, proponents argue that this approach would help both public and private companies. Furthermore, proponents of View B state that this approach will not create recognition and measurement differences within U.S. GAAP.
- 24. Opponents of View B argue that because the example focuses on identifying the primary beneficiary, which is the last step before consolidation, private companies are not really getting relief. Private companies would still have to incur the costs of performing the entire VIE assessment. Those opponents also believe that this approach could lead to unintended consequences in applying VIE guidance for other arrangements.

View C: Clarifying the Identification of Variable Interest. Provide implementation guidance on how to identify variable interests in common control leasing arrangements.

- 25. Under View C, the PCC should recommend the following changes to existing VIE guidance:
  - a. The Board should remove the FSP example from paragraphs 810-10-55-88 through 55-89.

- b. The Board should add implementation guidance using a similar fact pattern to the one in the FSP example, but clarify that a variable interest, such as an implied guarantee on Leasing Entity's debt, does not exist.
- 26. View C clarifies the confusion that exists on how to identify implicit variable interest in private company arrangements similar to the FSP example. View C could exempt lessee entities without a variable interest in lessor entities from performing the rest of the VIE assessment. View C takes a position that the FSP example contradicts the overall VIE model and does not appropriately consider purpose and design. View C would conclude that the potential implied guarantee within the FSP example is not a variable interest because it does not create and pass along variability (risk). Paragraph 810-10-25-22 states:

The variability to be considered in applying the Variable Interest Entities Subsections shall be based on an analysis of the design of the legal entity as outlined in the following steps:

- a. Step 1: Analyze the nature of the risks in the legal entity (see paragraphs 810-10-25-24 through 25-25).
- b. Step 2: Determine the purpose(s) for which the legal entity was created and determine the variability (created by the risks identified in Step 1) the legal entity is **designed to create and pass along to its interest holders** (see paragraphs 810-10-25-26 through 25-36). [Emphasis added.]
- 27. In the FSP example, the owner created Leasing Entity for purposes of leasing the manufacturing facility, its only asset, to Manufacturing Entity. If Manufacturing Entity does not make lease payments, then Leasing Entity is at risk of default on its debt because the lease payments are its only substantive source of income. An implied guarantee on Leasing Entity's debt is primarily absorbing the risk that Manufacturing Entity will not be able to make its lease payments. Because the VIE model stresses that the variability created by one entity is passed along to that entity's interest holders, Manufacturing Entity does not have a variable interest. Manufacturing Entity's implied guarantee on Leasing Entity's debt is not a variable interest because it absorbs a risk created by its holder.

- 28. The following draft paragraphs would amend the implementation guidance in Subtopic 810-10 to clarify how to identify the variable interest under common control leasing arrangements:
  - **810-10-55-XX** The sole owner of Manufacturing Entity is also the sole owner of Leasing Entity, which is a VIE. The owner of Leasing Entity provides a guarantee of Leasing Entity's debt as required by the lender. Leasing Entity owns no assets other than the manufacturing facility being leased to Manufacturing Entity. The lease, with market terms, contains no explicit guarantees of the residual value of the real estate or purchase options and is therefore not considered a variable interest under paragraph 810-10-55-39. The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Entity and Leasing Entity.
  - **810-10-55-XX** Although the lease agreement itself does not contain a contractual guarantee, Manufacturing Entity may be expected to make funds available to Leasing Entity to prevent the owner's guarantee of Leasing Entity's debt from being called on, or Manufacturing Entity may be expected to make funds available to the owner to fund all or a portion of the call on Leasing Entity's debt guarantee. However, Manufacturing Entity's implied guarantee on Leasing Entity's debt is not a variable interest because it absorbs a risk created by its holder.
- 29. Proponents of View C agree with the principles of VIE guidance and believe that this alternative fixes a contradiction within existing VIE guidance. By reinforcing and clarifying the principles of the VIE model, proponents argue that this approach would help both public and private companies. Furthermore, proponents of View C state that this approach will not create recognition and measurement differences within U.S. GAAP.
- 30. Opponents of View C argue that this approach does not clarify the assessment of explicit variable interest under common control leasing arrangements. Those opponents also believe that this approach could lead to unintended consequences in applying VIE guidance for other arrangements. Opponents of View C argue that clarification of the model would still force private companies whose only VIE arrangement is a common control leasing arrangement to incur the costs of applying the VIE model. Those opponents note that common control leasing arrangements are ubiquitous among private companies and are often their only potential VIE arrangement.

## **Recurring Disclosures**

31. The staff believes that if the PCC concludes on View A, private companies should be required to make the disclosures proposed in paragraph 14 above. Those disclosures will enable the reporting entity to present its financial statements separately from the leasing entity under common control, while still providing transparency into its potential obligations as a result of its arrangement with the leasing entity. Furthermore, the disclosures require that the reporting entity disclose information key terms of any significant obligations held by the leasing entity. The staff believes that this proposal is consistent with the feedback received from users.

32. If the PCC concludes on View B or View C, the staff does not recommend any incremental disclosures to the existing VIE disclosure requirements as described in Section 810-10-50, Consolidation—Overall—Disclosure. View B and View C clarify the VIE model and do not change the accounting and disclosure principles under Topic 810. If a lessee entity determines it is not the primary beneficiary but is a variable interest holder, it must still make the applicable disclosures under Subtopic 810-10. If a lessee entity determines that it has no variable interest in the lessor entity, then current VIE guidance would require no disclosures on the lessor entity.

#### **Transition**

33. Presented below are two transition options for the PCC to consider.

Option A: Nonpublic entities should recognize the effect of the change as a change in accounting principle through retrospective application. Nonpublic entities would adjust opening retained

earnings for the earliest period presented following deconsolidation guidance provided in paragraph 810-10-65-2(e).<sup>2</sup>

34. Proponents of Option A observe that the FASB's Conceptual Framework describes comparability (including consistency) as one of the qualitative characteristics of accounting information. Those proponents refer to paragraph B7 of the Basis for Conclusions in FASB Statement No. 154, *Accounting Changes and Error Corrections*, which states that:

The Board concluded that retrospective application improves financial reporting because it enhances the consistency of financial information between periods. That improved consistency enhances the usefulness of the financial statements, especially by facilitating analysis and understanding of comparative accounting data.

35. Reporting entities that had previously consolidated lessor entities under common control would need to potentially deconsolidate them. Opponents of Option A are concerned with implementation challenges in retrospectively deconsolidating lessor entities.

Option B: Nonpublic entities should recognize the effect of the change as a change in accounting principle through a modified retrospective application. Nonpublic entities would adjust opening retained earnings for the current period presented following deconsolidation guidance provided in paragraph 810-10-65-2(e).

If a reporting entity is required to deconsolidate a VIE as a result of the initial application of the pending content in the Variable Interest Entities Subsections, the deconsolidating reporting entity shall initially measure any retained interest in the deconsolidated subsidiary at its carrying amount at the date the requirements of the pending content in the Variable Interest Entities Subsections first apply. In this context, carrying amount refers to the amount at which any retained interest would have been carried in the reporting entity's financial statements if the pending content in the Variable Interest Entities Subsections had been effective when the reporting entity became involved with the VIE or no longer met the conditions to be the primary beneficiary. Any difference between the net amount removed from the balance sheet of the deconsolidating reporting entity and the amount of any retained interest in the newly deconsolidated VIE shall be recognized as a cumulative-effect adjustment to retained earnings. The amount of any cumulative-effect adjustment related to deconsolidation shall be disclosed separately from any cumulative-effect adjustment related to consolidation of VIEs.

<sup>&</sup>lt;sup>2</sup> Paragraph 810-10-65-2(e) states:

36. Proponents of Option B believe that the information needed to retrospectively deconsolidate the lessor entity may not be readily available or determinable in all circumstances. They believe that the costs of getting that information outweigh the benefits of consistency and comparability. Opponents of Option B believe that this approach reduces consistency and comparability in financial reporting. Opponents of Option B also note that Section 250-10-45, Accounting Changes and Error Corrections—Overall—Other Presentation Matters, includes an impracticability exception provision for those situations in which it is impracticable to restate prior periods upon adoption of a new accounting standard.

## Transition—Staff Recommendation

37. The staff recommends Option A. Based on feedback received, the staff does not believe that retrospectively deconsolidating a lessor entity will be burdensome or costly for private companies. Users stated they often request consolidating schedules from a private company, which could be used by preparers to retrospectively adjust the private company's financial statements.

#### **Transition Disclosures**

38. The other presentation matters guidance in Subtopic 250-10 is applicable for any voluntary change in accounting principle, including a change in the method of applying an accounting principle. The staff recommends that the PCC propose that companies apply the disclosure requirements in Section 250-10-50 for an accounting change required by this Issue. Additionally, the staff recommends that the PCC not propose any additional disclosures other than the requirements in paragraphs 250-10-50-1 through 250-10-50-3.

## Appendix A

#### **FASB STAFF POSITION**

#### No. FIN 46(R)-5

Title:

Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities (This FSP is applicable to both nonpublic and public reporting enterprises. This issue commonly arises in leasing arrangements among related parties, and in other types of arrangements involving related parties and unrelated parties.)

**Date Posted:** March 3, 2005

- The Board directed the FASB staff to issue this FASB Staff Position (FSP) to address whether a reporting enterprise should consider whether it holds an implicit variable interest in a variable interest entity (VIE) or potential VIE when specific conditions exist.
- The identification of variable interests (implicit and explicit) may affect (a) the determination as to whether the potential VIE should be considered a VIE, (b) the calculation of expected losses and residual returns, and (c) the determination as to which party, if any, is the primary beneficiary of the VIE. Thus, identifying whether a reporting enterprise holds a variable interest in a VIE or potential VIE is necessary to apply the provisions of Interpretation 46(R).
- An implicit variable interest is an implied pecuniary interest in an entity that changes with changes in the fair value of the entity's net assets exclusive of variable interests. Implicit variable interests may arise from transactions with related parties, as well as from transactions with unrelated parties. Paragraph B10 of Interpretation 46(R) provides one example of an implicit variable interest; that is, an implicit agreement to replace impaired assets held by a variable interest entity that protects holders of other interests in the entity from suffering losses. However, Appendix B to Interpretation 46(R) is not intended to provide a complete list of all possible variable interests.
- The identification of explicit variable interests involves determining which contractual, ownership, or other pecuniary interests in an entity directly absorb or receive the variability of the entity. An implicit variable interest acts the same as an explicit variable interest except it involves the absorbing and (or) receiving of variability indirectly from the entity, rather than directly from the entity. Therefore, the identification of an implicit variable interest involves

determining whether an enterprise may be indirectly absorbing or receiving the variability of the entity. The determination of whether an implicit variable interest exists is a matter of judgment that depends on the relevant facts and circumstances. For example, an implicit variable interest may exist if the reporting enterprise can be required to protect a variable interest holder in an entity from absorbing losses incurred by the entity. Refer to the example in this FSP.

- 5. The FASB staff is aware of transactions where a reporting enterprise has an interest in, or other involvement<sup>3</sup> with, a VIE or potential VIE that is not considered a variable interest, and the reporting enterprise's related party<sup>4</sup> holds a variable interest in the same entity. A reporting enterprise's interest in, or other pecuniary involvement with, a VIE may take many different forms such as a lessee under a leasing arrangement or a party to a supply contract, service contract, or derivative contract. For these and other types of transactions, the FASB staff understands that there is diversity in practice as to whether the reporting enterprise should consider whether an implicit variable interest exists between it and the VIE or potential VIE.
- 6. The FASB staff believes the reporting enterprise should consider whether it holds an implicit variable interest in the VIE or potential VIE. The determination of whether an implicit variable interest exists should be based on all facts and circumstances in determining whether the reporting enterprise may absorb variability of the VIE or potential VIE. A reporting enterprise that holds an implicit variable interest in a VIE and is a related party<sup>5</sup> to other variable interest holders should apply the guidance in paragraph 17 of Interpretation 46(R) to determine whether it is the primary beneficiary of the VIE. That is, if the aggregate variable interests held by the enterprise (both implicit and explicit variable interests) and its related parties would, if held by a single party, identify that party as the primary beneficiary, then the party within the related party group that is most closely associated with the variable interest entity is the primary beneficiary. The determination of which party within the related party group is most closely associated with the variable interest entity requires judgment, and shall be based on an analysis of all relevant

<sup>3</sup> The significance of an enterprise's involvement or interest should not be considered in determining whether the enterprise holds an implicit variable interest in the entity.

<sup>4</sup> For purposes of this FSP, refer to paragraph 16 of Interpretation 46(R) for the definition of related party.

<sup>&</sup>lt;sup>5</sup> The guidance in this FSP applies to related parties as defined in paragraph 16 of Interpretation 46(R). For example, the guidance in this FSP applies to situations in which (1) a reporting enterprise and a VIE are under common control, (2) a reporting enterprise has an interest in, or other involvement with, a VIE and an officer of that reporting enterprise has a variable interest in the same VIE, or (3) a reporting enterprise enters into a contractual arrangement with an unrelated third party that has a variable interest in a VIE and that arrangement establishes a related party relationship.

facts and circumstances. Paragraph 17 of Interpretation 46(R) provides factors to consider in making that determination. A reporting enterprise that is not the primary beneficiary but holds an implicit variable interest in a VIE should disclose the information in paragraph 24 of Interpretation 46(R).

#### **Effective Date and Transition**

7. For entities to which Interpretation 46(R) has been applied, the guidance in this FSP shall be applied in the first reporting period beginning after March 3, 2005 in accordance with the transition provisions of Interpretation 46(R). Restatement to the date of the initial application of Interpretation 46(R) is permitted but not required. Early application is permitted for periods for which financial statements have not yet been issued. For entities to which Interpretation 46(R) has not been applied, the guidance in this FSP shall be applied in accordance with the effective date and transition provisions of Interpretation 46(R).

## Example

One of the two owners of Manufacturing Company is also the sole owner of Leasing Company, which is a VIE. The owner of Leasing Company provides a guarantee of Leasing Company's debt as required by the lender. Leasing Company owns no assets other than the manufacturing facility being leased to Manufacturing Company. The lease, with market terms, contains no explicit guarantees of the residual value of the real estate or purchase options and is therefore not considered a variable interest under paragraph B24 of Interpretation 46(R). The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Company and Leasing Company.

Based on the guidance in this FSP, Manufacturing Company should consider whether it holds an implicit variable interest in Leasing Company.

Although the lease agreement itself does not contain a contractual guarantee, Manufacturing Company should consider whether it holds an implicit variable interest in Leasing Company as a result of the leasing arrangement and the relationship between it and the owner of Leasing Company. For example, Manufacturing Company would be considered to hold an implicit variable interest in Leasing Company if Manufacturing

Company effectively guaranteed the owner's investment in Leasing Company. Manufacturing Company may be expected to make funds available to Leasing Company to prevent the owner's guarantee of Leasing Company's debt from being called on, or Manufacturing Company may be expected to make funds available to the owner to fund all or a portion of the call on Leasing Company's debt guarantee. The determination as to whether Manufacturing Company is effectively guaranteeing all or a portion of the owner's investment or would be expected to make funds available and, therefore, an implicit variable interest exists, should take into consideration all the relevant facts and circumstances. Those facts and circumstances include, but are not limited to, whether there is an economic incentive for Manufacturing Company to act as a guarantor or to make funds available, whether such actions have happened in similar situations in the past, and whether Manufacturing Company acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

\_

<sup>&</sup>lt;sup>6</sup> The guidance in this FSP should be used only to evaluate whether a variable interest exists under Interpretation 46(R) and should not be used in the evaluation of lease classification in accordance with FASB Statement No. 13, *Accounting for Leases*. Paragraph 29 of Statement 13 addresses leases between related parties and states "...the classification and accounting shall be the same as for similar leases between unrelated parties, except in cases where it is clear that the terms of the transaction have been significantly affected by the fact that the lessee and lessor are related. In such cases the classification and/or accounting shall be modified as necessary to recognize economic substance rather than legal form. The nature and extent of leasing transactions with related parties shall be disclosed."



Memorandum

Memo No. PCDMF 2

Issue Date July 3, 2013

Meeting **PCC: July 15, 2013** 

Topic	Comment Letter Summary			
Project	Private Company Decision-Making Framework			
	Kailee Boyce	kboyce@fasb.org	203-956-5353	
	Callie Haley	cmhaley@fasb.org	203-956-5298	
	Chiara Gilioli	cgilioli@fasb.org	203-956-5283	
Contact(s)	Michael Cheng	mkcheng@fasb.org	203-956-5236	

## **Purpose**

- 1. This memo provides a summary of the comments in the 34 letters received in response to the Invitation to Comment, *Private Company Decision-Making Framework—A Guide for Evaluating Financial Accounting and Reporting for Private Companies*, issued on April 15, 2013.
- 2. The memo is organized as follows:
  - a. Background
  - b. Comment Letter Respondents by Category
  - c. Summary of Comments Received
  - d. Next Steps.
- 3. The staff's analysis of the comments summarized in this memo and possible next steps for the Private Company Council (PCC) and the Board are discussed in Memorandum PCDMF 3.

## Background

- 4. On July 31, 2012, the FASB issued a Discussion Paper, *Private Company Decision-Making Framework—A Framework for Evaluating Financial Accounting and Reporting Guidance for Private Companies*, with a comment period ending on November 9, 2012. Fifty-seven comment letters were received on the 2012 Discussion Paper. Overall, respondents were supportive of the project and its purpose. However, there were a few questions that received a wide range of responses and opinions.
- 5. At the December 7, 2012, and February 12, 2013, PCC meetings, the PCC and the Board deliberated the comments received on the 2012 Discussion Paper. On April 15, 2013, the PCC and the Board issued an updated Invitation to Comment, which reflects the views of the PCC and the Board after considering respondents' comments as well as the views received through other outreach initiatives on the 2012 Discussion Paper. The PCC and the Board decided to expose the updated Invitation to Comment because the 2012 Discussion Paper had not been deliberated by either organization when it was issued. The decision to expose the 2013 Invitation to Comment was not the result of any significant continuing concerns raised during the deliberation process. The following are the significant differences between the 2012 Discussion Paper and the 2013 Invitation to Comment:
  - a. The 2012 Discussion Paper included a presumption that industry-specific guidance for recognition and measurement is relevant to financial statement users of both public companies and private companies. As a result, that Discussion Paper excluded industry-specific guidance from the consideration of alternatives for private companies within U.S. generally accepted accounting principles (GAAP). The 2013 Invitation to Comment does not include a presumption, and thus, the PCC and the Board would consider whether the same industry-specific guidance is relevant to financial statement users of both public companies and private companies. If not, then the PCC and the Board can consider alternatives within U.S. GAAP for that industry-specific guidance for private companies.

b. The 2012 Discussion Paper was silent on whether to require a private company to elect all applicable recognition or measurement alternatives within U.S. GAAP or to allow flexibility to choose which recognition and measurement alternatives are appropriate for a private company. The 2013 Invitation to Comment would generally allow a private company to select the alternatives within recognition and measurement guidance that it deems appropriate to apply without having to apply all alternatives within recognition and measurement. However, in certain circumstances, the PCC and the Board may require that application of alternatives for private companies within recognition or measurement in one area be linked to the application in another area.

## **Comment Letter Respondents by Category**

6. The following table provides demographic statistics on the comment letters received:

Constituency Type	<b>Constituency Count</b>
Professional Organization	9
Industry Organization	10
Individual	3
Practitioner	11
Financial Institution	1
Grand Total	34

## **Summary of Comments Received**

- 7. The 2013 Invitation to Comment included the following questions:
  - a. General respondent information (Question 1)
  - b. Differential factors (Question 2)

- c. User relevance (Question 3)
- d. Industry-specific guidance (Question 4)
- e. Primary information needs of users, access to management, and the *red-flag* approach (Question 5)
- f. Recognition and measurement questions for the PCC and the Board (Question 6)
- g. All or nothing (Question 7).

#### General Respondent Information (Question 1)

8. The first question in the 2013 Invitation to Comment asked respondents about their experience and background. That information is presented in the table above. The staff notes that significantly fewer comment letters were received on the 2013 Invitation to Comment as compared with the 2012 Discussion Paper. However, only two significant changes were made to the 2013 Invitation to Comment and numerous respondents noted that their comments from the 2012 Discussion Paper still apply to the 2013 Invitation to Comment. Thus, the staff is not concerned that so few comment letters were received.

#### Differential Factors (Question 2)

9. Question 2 of the Invitation to Comment asks the following:

Do you agree that this guide is based on the appropriate differential factors between private companies and public companies (see paragraphs DF1–DF13)? If not, please explain why and include additional factors, if any, that you believe should be considered along with their potential implications to private company financial reporting.

- 10. The following are the six differential factors:
  - I. Types and number of financial statement users
  - II. Access to management
  - III. Investment strategies of equity investors
  - IV. Ownership and capital structures

- V. Accounting resources
- VI. Learning about new financial reporting guidance.
- 11. Virtually all respondents agreed that the guide within the Invitation to Comment is based on the appropriate differential factors between private companies and public companies. Out of the 26 respondents that answered question 2, 25 agreed that all 6 of the differential factors are appropriate.
- 12. Eight of those 25 respondents suggested adding additional differential factors between private and public companies, such as complexity of the entity's operations, the size of the entity, regulatory oversight, and confidentiality of financial information.
- 13. In regards to the addition of company size as a consideration, Lamplighter Financial (CL #13) stated the following:

One other consideration that should be evaluated in defining "Private" and "Public" is company size (as defined by sales, number of shareholders, or number of/type of stakeholders). For example, should a company with annual revenue exceeding \$100B be considered a "Public" company (or a "Large Private" company) for reporting purposes? A private company of this size would have a more robust accounting department and may not face the same burdens and difficulties in reporting that a smaller private company might. Additionally, large private companies may have a larger number of individual investors relying on their financial statements, placing them somewhere between a public company (responsible for reporting to shareholders) and a small private company (responsible for reporting to a handful of investors and their bank).

14. One respondent felt that the differential factors were not appropriate. The International Association of Consultants, Valuators and Analysts (IACVA), disagreed with factors II, III, and IV. It cites examples of matrimonial matters in which there is no access to management and in which the disclosures described in the guide would be insufficient for the users. The IACVA (CL #11) suggested that factor II, Access to Management, be removed and replaced by a requirement for a Management Analysis & Discussion. The IACVA also stated that factors III and IV

often do not apply "as an increasing number of private companies have venture capital or private equity investments."

## **User Relevance (Question 3)**

15. Question 3 of the Invitation to Comment asks the following:

Overall, do you agree that this guide would lead to decisions that provide relevant information to users of private company financial statements in a more cost-effective manner? If it does not, what improvements can be made to achieve those objectives?

- 16. Of the 24 respondents to question 3, 13 agreed, 6 conditionally agreed, and 5 disagreed that the guide would lead to user relevant information in a more cost-effective manner.
- 17. Respondents that conditionally agreed did so for a variety of reasons. Some of their comments were related to the questions in paragraph 1.5, which are addressed later in this summary. Others suggested that more emphasis should be placed on cost and complexity and/or access to management.
- 18. One of the respondents that conditionally agreed that the guide would lead to user-relevant information in a cost-effective manner is the Private Companies Practice Section Technical Issues Committee of the American Institute of Certified Public Accountants (TIC). Overall, TIC (CL #33) agrees that the guide will lead to decisions that adequately address cost-benefit concerns, with the following exception:

When a private company has applied an alternative transition method, paragraph 5.3 of the proposed guide requires disclosure of qualitative information about how the amendments required by a FASB ASU would affect the comparison of its current-period financial statements with its prior-period financial statements.

However, the last sentence of paragraph 5.3 would also require the Board and the PCC to consider an additional requirement for the disclosure of quantitative information "depending on the nature of the amendment to existing guidance." TIC believes this additional requirement would defeat the purpose of permitting the application of an alternative transition method. In most cases, the quantitative

information could not be assembled without effectively expending the same level of effort as would be required for a full retrospective transition method. A requirement to calculate such quantitative information on a line-by-line basis would be onerous for preparers and would not be cost beneficial. TIC therefore recommends that the last sentence of paragraph 5.3 be deleted from the final guide.

19. Of the 5 respondents that disagreed, 3 stated that the guide either would not lead to decisions that provide relevant information to users or it would add cost and complexity for users, preparers, and practitioners. KPMG (CL #25) stated the following:

Differences in accounting requirements may add to cost and complexity for users due to differences between public and private company reporting and differences among private companies as a result of some private companies electing alternatives and others not. Complexity may also increase as a result of preparers and auditors being required to know and understand multiple alternative treatments. Multiple alternatives, transition options, and different effective dates also create additional complexity in the standard-setting process, including how those requirements are presented within the FASB's Accounting Standards Codification. Potential reductions in complexity in the application of specific provisions of accounting requirements should be considered in light of the potential overall impact on the standard-setting process and financial reporting system.

20. The guide states that more weight should be placed on considerations related to relevance as opposed to cost and complexity considerations. Two respondents disagreed with that approach and suggested that the guide places too much emphasis on user needs over other factors. One of those respondents said that access to management is the key differential factor. Although they said that the guide would result in relevant and cost-effective decisions, they disagreed with the emphasis on user needs over other factors in the guide. The other respondent that disagreed suggested that cost and complexity should be the primary filter or consideration and then, if the guidance is determined to be relevant, practical expedients should be provided.

#### Industry-Specific Guidance (Question 4)

21. Question 4 of the Invitation to Comment asks the following:

With respect to industry-specific guidance:

- a. Do you agree that this guide appropriately considers industry-specific accounting guidance for private companies? That is, should private companies follow the same industry-specific guidance that public companies are required to follow in instances in which the Board and the PCC determine that the guidance is relevant to financial statement users of both public companies and private companies operating in those industries? If not, why?
- b. Do you think factors other than user relevance, such as cost and complexity, should be considered when the Board and the PCC are determining whether or not to provide alternatives within industry-specific guidance?
- c. Do you think that industry-specific accounting considerations should be different between (i) recognition and measurement and (ii) disclosure?
- 22. Twenty-four respondents answered question 4(a), 13 respondents answered question 4(b), and 17 respondents answered question 4(c).
- 23. Thirteen respondents agreed that the guide appropriately considers industry-specific accounting guidance for private companies. Seven of those respondents suggested that cost and/or complexity should be considered in addition to user relevance by the PCC and the Board.
- 24. Some respondents that agreed with the guide's consideration of industry-specific accounting guidance added that recognition and measurement differences between private and public companies within industry-specific guidance should be rare. However, those respondents were more amenable toward the idea of providing differences in disclosure.
- 25. McGladrey (CL #14) stated the following:

While we believe the primary factor that should be considered in determining whether or not to provide alternatives for private companies within industry-specific guidance is user relevance, we also believe secondary factors for consideration are cost and complexity. For example, we would encourage the application of practical expedients in situations where there is a more cost-effective manner to accomplish a similar objective.

We believe there generally should be more flexibility in industry-specific disclosure alternatives than industry-specific recognition and measurement alternatives; however, we believe the guide's focus on user relevance should appropriately accomplish this objective.

26. Four respondents said that consideration of industry-specific guidance should be no different than the consideration of any other guidance. Two of those respondents represented credit unions that were concerned that the flexibility afforded by alternatives for private companies within U.S. GAAP would be lessened by the rebuttable presumption as written in the guide. A respondent that said consideration should be no different between industry-specific guidance and other guidance was the National Venture Capital Association (CL #31). It suggested that the entire section on industry-specific guidance should be removed from the final version of the guide. Its comment letter stated the following:

As stated in our comment letter on the Discussion Paper, the "Significant Differential Factors" that underlay the whole purpose of the PCC apply in the venture capital industry. We are therefore concerned that, while Paragraph 1.11 avoids the highly-prejudicial "presumption" language of the Discussion Paper, it still places private companies that report under "industry-specific" guidance in a disadvantageous position. [Footnote reference omitted.]

We are especially concerned about the phrase "[r]egardless of other factors that differentiate private companies from public companies" that begins the third sentence of Paragraph 1.11. It could easily be read as a subtle means of retaining the inappropriate presumption that private companies that use industry-specific guidance should be subject to special scrutiny or presumptions despite the fact that the Significant Differential Factors or an analysis of benefits and costs under Paragraph 1.4 clearly indicate that an alternative is appropriate.

Therefore, we urge that the section of the Framework titled "Industry-Specific Guidance" (Paragraphs 1.11 – 1.13) be dropped from the final Framework. At a minimum, the phrase "[r]egardless of other factors that differentiate private companies from public companies" in Paragraph 1.11 should be excised from the final document.

27. Eight respondents disagreed with the guide's consideration of industry-specific accounting guidance and said that there should be no differences between private companies and public companies within industry-specific accounting guidance. The Accounting Principles Committee of the Illinois CPA Society (CL #18) stated the following:

The Committee believes that both private companies and public companies should continue to apply the required industry guidance due to characteristics and nuances relevant and unique to those industries. Industry-specific guidance, by its very nature, is of critical importance to the users of financial statements of entities within those industries, and should be required regardless of an entity's ownership structure.

28. Four of the 8 respondents that disagreed represent electric cooperatives that use the accounting guidance in *FASB Accounting Standards Codification*® Topic 980, Regulated Operations. Those respondents said that there should be no differences in recognition and measurement within industry-specific guidance between private companies and public companies but added that it would be appropriate for the PCC and the Board to consider disclosure alternatives for private companies. The National Rural Utilities Cooperative Finance Corporation (CL #28) stated the following:

We believe that ASC 980 is equally relevant to users of both private electric utility company and public electric utility company financial statements in evaluating financial performance. The electric industry is very capital intensive and as such, the cooperative electric utilities as a whole are competing against other electric utilities for capital. As stated above, we believe it is important to maintain consistency and comparability for all electric company financial reporting.

We believe there should be comparability in the base financial results reported, thus recognition and measurement should be consistent within an industry. We do believe that there is an opportunity to reduce the cost and complexity of GAAP compliance for private companies through allowing alternative (i.e., reduced) footnote disclosure requirements, such as the extensive fair value footnote disclosures that are required under current U.S. GAAP.

## Primary Information Needs of Users, Access to Management, and the Red-flag Approach (Question 5)

29. Question 5 of the Invitation to Comment asks respondents for their comments on two related concepts within the proposed framework, which are the primary information needs of users and access to management and the red-flag approach.

Do the different sections of this guide appropriately describe and consider the primary information needs of users of private company financial statements and the ability of those users to access management, and does the disclosure section appropriately describe the *red-flag approach* often used by users when reviewing private company financial statements (see paragraphs BC45 and BC46)? If not, why?

Primary Information Needs of Users of Private Company Financial Statements and the Ability to Access Management

- 30. Nine of the 22 respondents agreed while another 9 respondents conditionally agreed and 4 respondents disagreed.
- 31. The respondents that expressed conditional agreement emphasized that although access to private companies' management is a differential factor, there might be cases when that access is limited only to certain users. The Association of Accountants and Financial Professionals in Business stated (CL #10) the following:

...there were examples where outside investors or auditors of nonpublic companies were not given access, but were stonewalled in their requests for information to determine the liquidity and solvency of the company. This apparent conflict makes it very difficult to present a presumption regarding the factors unique to private companies. We conclude that there may be situations where user access may be impaired and, therefore, there should be no presumption of access.

32. Two of the respondents that conditionally agreed stated that the framework should further emphasize the relevance of the access to the management differential factor. The National Venture Capital Association (CL #31) stated:

...we do not think that the ED Framework places sufficient emphasis on the significance of management access as a basis for different accounting requirements for private companies, especially disclosure requirements.

33. Some respondents disagreed with the guide for a variety of reasons. One respondent stated that access to management should not be considered in determining alternatives for private companies within U.S. GAAP because access to management is not equally available to all users. Another respondent stated that general purpose financial statements should not be modified based on access to management and that the guide would lead to two separate sets of U.S. GAAP.

#### Red-Flag Approach

- 34. Seven of the 21 respondents agreed while 11 respondents conditionally agreed and 3 respondents disagreed with the description of the red-flag approach within the disclosure section of the guide.
- 35. Among the respondents that conditionally agreed to the appropriate description of the red-flag approach, some indicated that more guidance should be provided for the application of the red-flag approach because the description included in the guide is still broad in scope and open to subjective interpretation. In addition, other respondents noted that the red-flag approach might not be suitable for certain types of disclosures related to industry-specific sectors or certain matters such as contingencies. Those respondents also were concerned that the amount of disclosure provided with the application of the red-flag approach might not be sufficient to inform users with a limited access to management.
- 36. The respondents that disagreed with the red-flag approach were primarily concerned with the fact that access to management is not consistent between users or private companies. The IACVA (CL #11) stated that "...access to management is not always available; therefore we see no advantage in moving to a red-flag approach."

### Recognition and Measurement Questions for the Board and the PCC (Question 6)

37. Question 6 of the Invitation to Comment asks the following:

Paragraph 1.5 includes the following questions for the Board and the PCC to consider in the recognition and measurement area of the guide:

1.5(e) Does the guidance require that the threshold for recognizing or measuring a transaction or event be at least probable of occurring?

- 1.5(h) Is it likely that users that are interested in the transaction, event, or balance can obtain information directly from management that can reasonably satisfy the objective of the guidance?
- 1.5(i) Is the lag between the year-end reporting date and the date financial statements are issued and made available to users likely to significantly dilute the relevance of the information resulting from the guidance?

Do you believe that the questions listed above are necessary for considering alternatives for private companies within recognition and measurement guidance? Or are the other questions in paragraph 1.5 sufficient for considering when alternative recognition and measurement guidance is appropriate for private companies within U.S. GAAP?

- 38. Eleven of the 23 respondents agreed while 8 respondents conditionally agreed and 4 respondents disagreed that questions 1.5(e), 1.5(h), and 1.5(i) are necessary for considering alternatives for private companies within recognition and measurement guidance.
- 39. Among the respondents that expressed conditional agreement, five respondents stated that question 1.5 (i) should be eliminated from the guide.
- 40. Among the respondents that disagreed with the questions, three of them stated that questions 1.5 (e), 1.5 (h), and 1.5 (i) should be eliminated from the guide. PricewaterhouseCoopers (CL #6) stated the following:

We recommend question (e) be eliminated from the guide. A significant premise behind the establishment of the PCC and the need to more explicitly consider the needs of private companies and users of their financial statements was that a separate conceptual framework should not be established for private companies. This question appears to suggest financial statement concepts unique to private companies, which we believe should be avoided.

We recommend question (h) be eliminated from the guide. Consistent with our position regarding the challenges of the application of the *red-flag* approach, we caution that there may not be sufficient consistency of access to management from company to company to justify including this as a factor in the decision making framework with respect to recognition and measurement.

We recommend question (i) be eliminated from the guide. Due to the need to compile information to prepare financial reports, financial reporting, by necessity, results in a reporting lag. We acknowledge that there is typically a longer lag period between the year-end date and the financial statement issuance date for private companies than there is for public companies. Although the length of the period can vary, frequently it is only thirty to sixty days longer for private companies. This additional lag in reporting neither dilutes a user's need for financial information nor the relevance of the financial information otherwise determined to be useful. Therefore, we do not believe that the lag should justify differences in recognition and measurement between private companies and public companies.

## All or Nothing (Question 7)

41. Question 7 of the Invitation to Comment asks the following:

Do you agree that a private company generally should be eligible to select the alternatives within recognition or measurement guidance that it deems appropriate to apply without being required to apply all alternatives available to private companies within recognition and measurement? Do you agree that, in certain circumstances, the Board and the PCC may link eligibility for application of alternatives within recognition or measurement in one area to the application in another area? If not, why?

- 42. Of the 34 respondents, 28 respondents commented on question 7. Seventeen respondents supported the proposal to provide the option for the private companies to select alternatives within recognition or measurement guidance without being required to apply all alternatives available to private companies (that is, an elective approach) and the possibility that the PCC and the Board may link eligibility for application of alternatives. Eight respondents conditionally supported the proposal and three respondents disagreed with the proposal.
- 43. Respondents that agreed with the elective approach stated that the PCC and the Board did not intend to create separate U.S. GAAP for private companies. Requiring all recognition and measurement guidance to be adopted would, in effect, result in a separate set of U.S. GAAP for private companies. Furthermore, supporters of the elective approach stated that it alleviates preparer concerns about the requirement to apply all future private company alternatives without the ability to assess the impact on relevancy of accepting an "all-or-nothing" approach. Among the supporters of the elective approach, five respondents did not comment

on the possibility for the PCC and the Board to link eligibility for application of alternatives within recognition or measurement in one area to the application in another area.

- 44. Two of the respondents that conditionally agreed noted that linking the eligibility for application of alternatives within recognition and measurement in one area to the application in another area might be appropriate in limited circumstances. The Credit Union National Association (CL #23) further expanded this concept by stating that they "... urge FASB and the PCC to allow private companies to make those determinations."
- 45. There were no respondents that specifically disagreed with the PCC and the Board on linking eligibility for application of alternatives within recognition or measurement in one area to the application in another area.
- 46. Most of the respondents that disagreed with the adoption of the elective approach argued that its adoption would potentially cause comparability issues among the financial statements of different companies.

#### Miscellaneous Feedback Received

- 47. There were a number of issues raised that did not directly address the questions asked by the PCC or the Board within the Invitation to Comment. Those issues are addressed in paragraphs 48 and 49.
- 48. TIC (CL #33) stated the following in its comment letter:

TIC believes the proposed guide is sufficiently robust to be used immediately, especially in the development of new proposed Accounting Standards Updates (ASUs). TIC therefore encourages the Board and the PCC to apply its provisions to the two exposure drafts relating to Financial Instruments (Credit Losses and Recognition and Measurement) before they are issued as final ASUs.

49. Deloitte & Touche (CL #16) stated that consideration should be given to the following:

- a. Circumstances in which public companies that have unconsolidated investments in private companies that apply the framework's alternatives would be required to make adjusting entries to undo the application of any private-company-only alternative to properly reflect the results of the investment within the public company's financial statements.
- b. Guidance that private companies need to follow when they change an accounting policy either from or to the permitted alternatives for private companies (that is, how the accounting policy should be determined for private companies that intend to switch from one alternative to another permissible alternative).

## **Next Steps**

50. The staff will discuss next steps with the PCC and the Board in memorandum PCDMF 3.



Memorandum

Memo No. PCDMF 3

Issue Date **July 12, 2013** 

Meeting PCC: July 16,

2013

Contact(s)	Michael Cheng Chiara Gilioli	mkcheng@fasb.org	203-956-5236 203-956-5283	
	Callie Haley	cmhaley@fasb.org	203-956-5298	
Project	Private Company Decision-Making Framework			
Topic	Guide Deliberations and Decisions			

## **Purpose**

1. The purpose of this memo is to consider proposed changes to the proposed Private Company Decision-Making Framework (guide) resulting from feedback received on the Invitation to Comment (ITC) issued on April 15, 2013. Comment letters on the 2013 ITC have been summarized in memorandum No. PCDMF 2.

## **Proposed Revisions**

## Differential Factors (Question 2 of the ITC)

2. Question 2 of the ITC relates to the appropriateness of the six differential factors identified by the PCC and the Board.

The six differential factors are:

- I. Types and number of financial statement users
- II. Access to management
- III. Investment strategies of equity investors
- IV. Ownership and capital structures

- V. Accounting resources
- VI. Learning about new financial reporting guidance.
- 3. Twenty-five of the 26 respondents who answered question 2 agreed that all 6 differential factors are appropriate. One of those respondents suggested that more emphasis be placed on factor IV, ownership and capital structures. Eight of those respondents suggested adding additional differential factors between private and public companies such as complexity of the entity's operations, the size of the entity, regulatory oversight, and confidentiality of financial information.
- 4. One respondent stated that differential factors II, III, IV were not appropriate. They cited examples of matrimonial matters where there is no access to management. They also stated that factors III and IV often do not apply for private companies.

#### Staff Recommendation

5. Virtually all of the respondents agreed that the guide identifies the appropriate differential factors between public and private companies. The staff recommends that the PCC and the Board reaffirm their previous decisions regarding the six differential factors.

## Question 1

Do the PCC and the Board wish to reaffirm their previous decisions regarding the six differential factors?

#### Overall Effectiveness of the Guide (Question 3 of the ITC)

6. Question 3 of the ITC asked respondents the following:

Overall, do you agree that this guide would lead to decisions that provide relevant information to users of private company financial statements in a more cost-effective manner? If it does not, what improvements can be made to achieve those objectives?

- 7. Of the 24 respondents to question 3, 13 agreed, 6 conditionally agreed, and 5 disagreed that the guide would lead to user-relevant information in a more cost-effective manner.
- 8. Respondents who conditionally agreed suggested that more emphasis be placed on cost and complexity and/or access to management.
- 9. One of the respondents who conditionally agreed that the guide would lead to user-relevant information in a cost-effective manner is the Private Companies Practice Section Technical Issues Committee of the American Institute of Certified Public Accountants (TIC). Overall, TIC (CL #33) agreed that the guide would lead to decisions that adequately address cost-benefit concerns. However, the TIC expressed concerns about the necessity of providing quantitative disclosures when a private company applyies an alternative transition method for private companies as mentioned in paragraph 5.3 of the guide.

#### Staff Recommendation

10. The staff believes that the requirement of quantitative information regarding the adoption of an alternative transition method by a private company should only be considered in limited circumstances where the nature of the amendment to existing guidance affects information that users of private company financial statements find relevant. In making that determination, the staff believes that the PCC and the Board should consider whether the amendment significantly impacts important financial metrics such as reported cash balances, cash flows, adjusted EBITDA, working capital, and total borrowings. Accordingly, the staff is recommending the following changes to paragraph 5.3 (additions are <u>underlined</u> and deletions are <u>struck through</u>):

A private company should be required to disclose in the notes to financial statements if it has applied an alternative transition method. That disclosure should include, at a minimum, qualitative information about how the amendments affect the comparison of its current-period financial statements with its prior period financial statements. Depending on the nature of the amendment to existing guidance In limited circumstances, the Board and the PCC should consider whether

a private company also should disclose quantitative information about how the amendments affect the comparison of its current-period financial statements with its prior-period financial statements. Consideration of quantitative disclosures should be limited to amendments that significantly affect important financial metrics as listed in paragraphs 5.4(a) and 5.4(b).

#### Question 2

Do the PCC and the Board agree with the staff's recommendation regarding the changes in paragraph 5.3 as indicated above?

#### Industry-Specific Guidance (Question 4 of the ITC)

11. Question 4 of the ITC asked respondents the following:

With respect to industry-specific guidance:

- a. Do you agree that this guide appropriately considers industry-specific accounting guidance for private companies? That is, should private companies follow the same industry-specific guidance that public companies are required to follow in instances in which the Board and the PCC determine that the guidance is relevant to financial statement users of both public companies and private companies operating in those industries? If not, why?
- b. Do you think factors other than user relevance, such as cost and complexity, should be considered when the Board and the PCC are determining whether or not to provide alternatives within industry-specific guidance?
- c. Do you think that industry-specific accounting considerations should be different between (i) recognition and measurement and (ii) disclosure?
- 12. Of the 34 respondents to the ITC, 24 answered question 4(a), 13 answered question 4(b), and 17 answered question 4(c).
- 13. Thirteen respondents agreed that the guide appropriately considers industry-specific accounting guidance for private companies. Of the 13 who agreed, 7

- respondents suggested that cost and/or complexity should be considered in addition to user relevance by the PCC and the Board.
- 14. Some respondents who agreed with the guide's consideration of industry-specific accounting guidance added that recognition and measurement differences between private and public companies within industry-specific guidance should be rare. However, those respondents were more amenable toward the idea of providing differences in disclosure.
- 15. Four respondents said that consideration of industry-specific guidance should be no different than the consideration of any other guidance. Two of those respondents represented credit unions that were concerned that the flexibility afforded by alternatives for private companies within U.S. GAAP would be lessened by the rebuttable presumption as written in the guide. National Venture Capital Association (CL #31) stated that consideration should be no different between industry-specific guidance and any other guidance. The National Venture Capital Association suggested that the entire section on industry-specific guidance should be removed from the final version of the guide.
- 16. Eight respondents disagreed with the guide and added that there should be no differences between private companies and public companies within industry-specific accounting guidance.

#### Staff Recommendations

- 17. When considering alternative display guidance for private companies within U.S. GAAP, the guide states that there is a presumption that information that is important enough to be presented on the face of financial statements is relevant to most financial statement users. Therefore, in general, private and public companies should apply the same financial statement display guidance.
- 18. As the presumption exists for both nonindustry-specific guidance and industry-specific guidance, the staff believes that it is redundant for the PCC and the Board to separately consider industry-specific guidance within the Display module.

Do the PCC and the Board wish to remove special consideration for industry-specific guidance within the Display module?

19. Many respondents were more amenable to the idea of providing disclosure differences for industry-specific guidance than for recognition and measurement. As such, the staff recommends that the PCC and the Board add a consideration for cost and complexity in addition to user relevance when considering potential disclosure alternatives for private companies.

#### Ouestion 4

Do the PCC and the Board wish to add a consideration for cost and complexity in addition to user relevance within industry-specific guidance section of the Disclosure module?

#### Question 5

Do the PCC and the Board wish to reaffirm their decisions regarding the industry-specific consideration in the Recognition and Measurement module?

# Primary Information Needs of Users, Access to Management, and the Red-Flag Approach (Question 5 of the ITC)

20. Question 5 of the ITC asked respondents the following:

Do the different sections of this guide appropriately describe and consider the primary information needs of users of private company financial statements and the ability of those users to access management, and does the disclosure section appropriately describe the red-flag approach often used by users when reviewing private company financial statements (see paragraphs BC45 and BC46)? If not, why?

21. Overall, respondents either agreed or conditionally agreed with the ITC on access to management and the redflag approach. However, it appeared that respondents

were more amenable toward the idea of providing alternatives in disclosure when compared to the idea of providing alternatives in recognition and measurement.

#### Feedback on Access to Management

- 22. Nine of the 22 respondents agreed, another 9 respondents conditionally agreed, and 4 respondents disagreed.
- 23. Those respondents who expressed conditional agreement emphasized that although access to private companies' management is a differential factor, there might be cases when that access is limited only to certain users.
- 24. Two of the respondents who conditionally agreed stated that the framework should further emphasize the relevance of the access to the management differential factor.
- 25. Some respondents disagreed with the guide for a variety of reasons. One respondent stated that access to management should not be considered in determining alternatives for private companies within U.S. GAAP because access to management is not equally available to all users. Another respondent stated that general purpose financial statements should not be modified based on access to management and that it would lead to two separate sets of U.S. GAAP.

#### Feedback on Red-Flag Approach

- 26. Seven of the 21 respondents agreed, 11 respondents conditionally agreed, and 3 respondents disagreed with the description of the red-flag approach in the disclosure section of the guide.
- 27. Among the respondents who conditionally agreed to the appropriate description of the red-flag approach, some indicated that more guidance should be provided for the application of the red-flag approach because the description included in the guide is still broad in scope and open to subjective interpretation.
- 28. The respondents who disagreed with the red-flag approach were primarily concerned with the fact that access to management is not consistent between users of private company financial statements.

Access to Management in Recognition and Measurement

29. To address the concerns raised by constituents, the staff proposes the following:

View A: Reaffirm the decisions reached on access to management as it relates to the recognition and measurement module. Currently, access to management is considered in deciding whether a recognition and measurement alternative for private companies within U.S. GAAP should be permitted. However, paragraph 1.9 states that access to management should not be a dominant factor in deciding whether to permit an alternative within U.S. GAAP. The guide also states that access to management should be considered in determining recognition and measurement alternatives for private companies within U.S. GAAP.

**View B**: View B would remove access to management as a consideration in determining whether a recognition and measurement alternative for private companies should be permitted. However, the Board and the PCC would still consider access to management in determining a viable alternative for private companies within U.S. GAAP. View B would require the following changes:

- a. Amend paragraphs 1.4 and 1.5 as follows (additions are <u>underlined</u> and deletions are <u>struck through</u>):
  - 1.4 In analyzing benefits and costs, the Board and the PCC should take into account the questions listed in paragraphs 1.5 and 1.6 to the extent each is pertinent to the issue under consideration. In deciding whether to provide recognition and measurement alternatives for private companies within U.S. GAAP, the Board and the PCC should consider the questions listed in paragraphs 1.5 and 1.6. Some of the questions would be most applicable when the Board and the PCC are reconsidering the benefits and costs of existing guidance, while other questions would be most applicable when evaluating new guidance being deliberated for projects on the Board's current agenda.
  - 1.5 The first group of questions pertains to the relevance of information to typical users of private company financial statements <u>as follows: and the access that those users commonly have to the relevant information, as follows:</u>
- b. Remove question 1.5(h) from the guide.

h. Is it likely that users that are interested in the transaction, event, or balance can obtain information directly from management that can reasonably satisfy the objective of the guidance?

c. Amend paragraph 1.9 as follows:

1.9 As the Board and the PCC evaluate potential alternatives for private companies within U.S. GAAP, they should also consider the ability of users of private company financial statements to access management to obtain additional information beyond what is reported in financial statements. Management access should not be a dominant factor in deciding whether to permit an alternative for private companies within U.S. GAAP. Rather, access Access to management should be viewed as a mitigating factor in evaluating cost-benefit considerations, including the risk that some users might find public company recognition or measurement guidance to be more relevant. If the Board and the PCC limit alternatives for private companies to those areas of U.S. GAAP that do not have broad or significant relevance to typical users of private company financial statements, relatively few users are expected to need to access management to obtain the information for which alternatives have been applied.

**View C**: View C would remove consideration of access to management in the recognition and measurement module. In other words, access to management would no longer be considered in determining whether a recognition and measurement alternative should be permitted. Furthermore, access to management would no longer be considered in determining potential alternatives within recognition and measurement guidance.

#### Staff Analysis

- 30. Most respondents agreed that access to management is a differential factor between public and private companies; however, there was mixed feedback in determining the level of consideration in setting recognition and measurement guidance for private companies within U.S. GAAP.
- 31. Proponents of View A believe that access to management should be considered in determining recognition and measurement guidance for private companies. They also recognize that access to management is not consistent among all users of private company financial statements. Accordingly, they emphasize that access to management should not be a dominant factor in deciding whether to permit an

- alternative for private companies. Proponents of View A also believe that access to management should be considered in determining recognition and measurement alternatives for private companies within U.S. GAAP.
- 32. Proponents of view B believe that the determination of whether there is a sufficient basis for alternative recognition and measurement guidance should not include the consideration of access to management. They believe that this approach would alleviate the concern with placing too much weight on access to management. View B would still allow the Board and the PCC to consider access to management in determining potential recognition and measurement alternatives.
- 33. Proponents of View C believe that there may not be sufficient consistency of access to management to justify including access to management as a factor in the guide with respect to recognition and measurement. Accordingly, there should be no presumption of access to management in the recognition and measurement module. Some proponents of View C believe that U.S GAAP modified based on access to management would ultimately lead to two separate sets of U.S. GAAP.

Do the PCC and the Board wish to reaffirm their decisions regarding the consideration of access to management in the disclosure module?

## Question 7

Which view do the PCC and the Board support regarding considerations of access to management within the recognition and measurements module?

#### Recognition and Measurement Questions for the PCC and the Board (Question 6 of the ITC)

- 34. Question 6 of the ITC asked respondents to consider whether the following considerations were necessary in considering alternatives for private companies within the recognition and measurement guidance:
  - 1.5(e) Does the guidance require the threshold for recognizing or measuring a transaction or event be at least probable of occurring?

- 1.5(h) Is it likely that users that are interested in the transaction, event, or balance can obtain information directly from management that can reasonable satisfy the objective of the guidance?
- 1.5(i) Is the lag between the year-end reporting date and the date financial statements are issued and made available to users likely to significantly dilute the relevance of the information resulting from the guidance?
- 35. Overall, respondents agreed that questions included in paragraph 1.5(a) through (i) were appropriate; although they noted that some questions were more relevant than others. However, 3 of the 23 respondents to question 6 recommended the removal of question 1.5(h), and 8 of the 23 respondents recommended the removal of question 1.5(i) from the recognition and measurement module.

#### Staff Recommendations

36. The staff believes that the list of questions included in paragraphs 1.5 and 1.6 should not be viewed at as an all-inclusive list to assess benefits and cost for private companies. Ultimately, the PCC and the Board will need to exercise judgement in making user relevance and cost and complexity evaluations. As such, the staff recommends adding the following sentence to the end of paragraph 1.4:

The questions included in paragraph 1.5 and 1.6 are not all-inclusive and the assessment of benefits and costs requires judgment.

37. In addition, the staff recommends that question 1.5 (i) should be removed from the guide based on feedback received. The staff also believes that consideration 1.5(i) is difficult to apply when determining whether a recognition and measurement alternative should be permitted.

#### **Question 8**

Do the PCC and the Board agree with the staff's recommendation to amend paragraph 1.4 and to remove question 1.5(i)?

#### All or Nothing (Question 7 of the ITC)

- 38. Question 7 of the ITC asked the respondents whether they agreed that:
  - a. A private company should be eligible to select the alternatives within recognition or measurement guidance (elective approach) that it deems appropriate without being required to apply all alternatives available to private companies?
  - b. It would be appropriate for the Board and the PCC, in certain circumstances, to link eligibility for application of alternatives within recognition or measurement in one area to the application in another area?
- 39. An overwhelming majority of respondents agreed with items (a) and (b) above. Respondents who agreed with the elective approach stated that the PCC and the Board did not intend to create a separate set of U.S. GAAP for private companies. Requiring all recognition and measurement guidance to be adopted would, in effect, result in a separate set of U.S. GAAP for private companies. Furthermore, supporters of the elective approach stated that the approach alleviates preparer concerns about the requirement to apply all future private company alternatives without the ability to assess the impact on relevancy of accepting an "all-ornothing" approach. However, several supporters of the elective approach emphasized the need for appropriate disclosure when financial statements are presented using an alternative recognition and measurement basis within U.S. GAAP.
- 40. Supporters of the all-or-nothing approach argued that complexity would increase if private companies did not have to apply all of the alternatives for recognition and measurement.

#### Staff Recommendation

- 41. The staff believes that the need for disclosure has been addressed within paragraph 1.10 of the proposed guide and recommends that no revisions should be made to the guide in relation to that issue.
- 42. The staff recommends that the PCC and the Board reaffirm their decision to allow a private company to select the appropriate alternatives within recognition or

measurement and to have the PCC and the Board, in certain circumstances, link the eligibility for application of alternatives within recognition or measurement.

## Question 9

Do the PCC and the Board wish to reaffirm their decision allowing a private company to select the appropriate alternatives within recognition or measurement and having the PCC and the Board, in certain circumstances, link the eligibility for application of alternatives within recognition or measurement?

#### Change in Accounting Principle

- 43. Based on feedback received, certain stakeholders would like the PCC and the Board to provide private companies with guidance when changing an accounting policy either from or to the permitted alternatives for private companies (that is, how the accounting policy should be determined for private companies that intend to switch from one alternative to another permissible alternative).
- 44. Topic 250, Accounting Changes and Error Corrections, requires an accounting principle adopted for the preparation of financial statements to be applied consistently when accounting for similar events and transactions. However, an entity may change an accounting principle (that is, adopt a "voluntary change") if it justifies the use of an allowable alternative accounting principle on the basis that it is preferable. Paragraph 250-10-55-1 states:

...preferability among accounting principles shall be determined on the basis of whether the new principle constitutes an improvement in financial reporting and not on the basis of the income tax effect alone.

#### Staff Recommendation

45. The staff believes that initial adoption of private company alternatives within U.S. GAAP should not be subject to a preferability assessment. Accordingly, although a private company would be required to disclose which alternative within U.S.

GAAP has been chosen, it would not be required to justify why a private company alternative is preferable to other recognition and measurement alternatives.

## Question 10

Do the PCC and the Board agree with the staff's recommendation to not require a preferability assessment upon initial adoption of private company alternatives within U.S. GAAP?

## Question 11

Do the PCC and the Board wish to provide guidance on switching from a private company alternative within U.S. GAAP?

#### Determining the Effective Date of Guidance

46. The proposed guide states that generally, private companies should be provided with a one-year deferral beyond the first annual period required for public companies to adopt new guidance. The guide also states that a private company should have the option to adopt the amendments before the deferred effective date for private companies but no earlier than the required or permitted date for public companies. Furthermore, private companies generally should not be required to adopt amendments during an interim period within the fiscal year of adoption.

#### Staff Analysis

47. Preparers of private company financial statements said that they primarily learn about new financial accounting and reporting guidance from their public accountants and that those education updates generally coincide with planning procedures of an audit or review of year-end financial statements. Those preparers also stated that their public accountants frequently are not involved in the interim financial reporting process because their users rarely require a review or audit of interim financial reports. As a result, preparers find it extremely burdensome and difficult to implement new accounting guidance during an interim reporting period.

- 48. Paragraph 47 of this memorandum serves as the basis for the current proposal in the guide. However, some share an alternative view of requiring private companies to adopt new accounting guidance during an interim period as long as the adoption date is at least one year after the effective date for public companies. Proponents of the alternative view believe that a one year deferral provides private companies with sufficient time to achieve significant efficiencies from observing the earlier implementation experiences of public companies—even if the adoption of the guidance is first applied during an interim period.
- 49. Proponents of the alternative view are most concerned with the fact that interim financial statements could be prepared on a basis that will be different from financial statements prepared at year-end. They believe that this will ultimately increase cost and complexity for both preparers and users. In such cases, a preparer will have to recast financial results presented at an interim period and explain to the users of their financial statements the difference in basis during the interim reporting period and the annual reporting period.
- 50. Proponents of the current proposal acknowledge the concerns raised, but they argue that the current proposal is more flexible because it already provides a private company with the option of adopting before the deferred effective date. Those proponents believe that the decision to adopt during an interim period or annual period should be left to the preparers and users of private company financial statements. In other words, the cost-benefit evaluation of reporting on an inconsistent basis between interim and annual reporting periods should be left to the preparers and users of private company financial statements.

Do the PCC and the Board wish to reaffirm their decision that private companies generally should not be required to adopt amendments during an interim period within the fiscal year of adoption?

Do the PCC and the Board wish to address any other issues related to the Private Company Decision-Making Framework?