July 1, 2013

FASB In Focus

Three Proposed Accounting Standards Updates on Private Company Proposals

Overview

The Financial Accounting Standards Board (FASB) on Monday, July 1, 2013, issued for public comment three proposals that address private company stakeholder concerns regarding the relevance and complexity of certain aspects of U.S. Generally Accepted Accounting Principles (GAAP). The proposals involve accounting for intangible assets acquired in business combinations, goodwill, and certain types of interest rate swaps.

Previously, the FASB on June 10, 2013, endorsed the three alternatives within U.S. GAAP proposed by the Private Company Council (PCC).

With the issuing of the three proposals, stakeholders are asked to provide comments on the Exposure Drafts by August 23, 2013.

Accounting for Identifiable Intangible Assets in a Business Combination

The first proposal—derived from PCC Issue No. 13-01A, *Accounting for Identifiable Intangible Assets in a Business Combination*—modifies the requirement for private companies to separately recognize fewer intangible assets acquired in a business combination.

The PCC received input from private company stakeholders indicating that the benefits of the current requirements do not justify the related costs. In response, the PCC conducted outreach with users of private company financial statements. Those users told the PCC that the requirement for separate recognition and measurement of certain identifiable intangible assets from goodwill in a business combination does not necessarily provide them with decision-useful information.

PCC Issue No. 13-01A, *Accounting for Identifiable Intangible Assets in a Business Combination,* enables private companies that elect the alternative within U.S. GAAP to recognize only those intangible assets arising from noncancelable contractual terms or those arising from other legal rights. Any other intangible assets would not be recognized separately from goodwill even if separable.

Users also indicated that the relevance of separately recognized intangible assets diminishes in periods subsequent to a business combination because the amortized carrying amounts of the intangibles no longer represent their fair values.

The PCC also received input from private company stakeholders, who expressed concerns about the cost and complexity of estimating the fair value of certain assets, including some identifiable intangible assets, such as customer relationships.

The proposed accounting alternative would be available to a company that is required to apply the acquisition method under Topic 805, Business Combinations, except for publicly traded companies and not-for-profit organizations.

The accounting alternative in the proposal is intended to provide a private company with an accounting alternative to recognize only those identifiable intangible assets arising from non-cancelable contractual terms or those arising from other legal rights.

The proposed accounting alternative would generally result in companies recognizing fewer intangible assets in a business combination than under current U.S. GAAP because not all identifiable intangible assets would be recognized, as required currently under Topic 805 (which requires an acquirer to recognize assets acquired and liabilities assumed in a business combination at their acquisition-date fair values, including all intangible assets that are identifiable).

The Board believes this would reduce the cost and complexity of valuing intangible assets acquired in a business combination.

Accounting for Goodwill Subsequent to a Business Combination

The second proposal—derived from PCC Issue No. 13-01B, *Accounting for Goodwill Subsequent to a Business Combination*—would permit amortization of goodwill (the residual asset recognized in a business combination after recognizing all other identifiable assets acquired and liabilities assumed) and a simplified goodwill impairment model.

In PCC Issue No. 13-01B, *Accounting for Goodwill Subsequent to a Business Combination*, goodwill would be amortized for a period not to exceed 10 years, and tested for impairment only when a triggering event occurs. Moreover, goodwill would be tested for impairment at the company-wide level as compared to the current requirement to test at the reporting unit level.

The PCC received input from private company stakeholders indicating that the benefits of the current requirements do not justify the related costs. During its outreach with users of private company financial statements, the PCC learned that the current accounting for goodwill impairment provides limited benefits to users because users often disregard goodwill and goodwill impairment losses in their analysis of a private company's financial condition and operating performance. Preparers and public accountants also told the PCC that they are concerned with the cost and complexity of the current goodwill impairment test.

The proposed accounting alternative would be available to a company that recognizes goodwill in a business combination in accordance with Topic 805, Business Combinations, except for publicly traded companies and not-for-profit organizations.

Currently, under U.S. GAAP goodwill is not amortized but tested for impairment at least annually or more frequently if certain conditions exist. A company can choose to first perform a qualitative assessment to determine if it is more likely than not that a reporting unit's fair value is less than its carrying value, or it can bypass the qualitative assessment and proceed directly to step one and compare the carrying value of the reporting unit with its fair value.

If the carrying value exceeds fair value, step two (which compares the implied fair value of the reporting unit's goodwill with its carrying value) must be performed to determine the amount of the goodwill impairment, if any. This necessitates performing a hypothetical application of the acquisition method under Topic 805 (also referred to as the purchase price allocation) to determine the implied fair value of goodwill and requires fair value measurement of the reporting unit's identifiable assets and liabilities.

Under the proposed accounting alternatives, a company that elects the accounting alternative within U.S. GAAP would amortize goodwill over the useful life of the primary asset (the long-lived asset that is the most significant asset acquired in a business combination), not to exceed 10 years.

Goodwill would be tested for impairment only when a triggering event occurs that would more likely than not reduce the fair value of a company below its carrying amount.

Further, goodwill would be tested for impairment at the company-wide level as compared to the current requirement to test at the reporting unit level. Step two of the current impairment test, which requires the application of a hypothetical purchase price allocation to calculate the goodwill impairment amount, would also be eliminated. Instead, the goodwill impairment amount would represent the excess of the company's carrying amount over its fair value.

The PCC believes that the proposed accounting alternative, when elected, would continue to provide decision-useful information to the users of private company financial statements, while reducing the cost and complexity associated with the current goodwill impairment test.

For example, the amortization method and option to not annually assess goodwill for impairment are expected to result in significant cost savings for many private companies that carry goodwill on their balance sheets, because these companies would only be required to assess goodwill for impairment in the event of a trigger. In addition, companies that have goodwill impairment would be subject to less cost and complexity when determining the goodwill impairment amount.

Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps

The third proposal—derived from PCC Issue No. 13-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps*—would offer private companies, other than financial institutions, the option to use two simpler approaches to accounting for certain types of interest rate swaps.

The PCC received input through outreach that private companies often find it difficult to obtain fixed-rate borrowing. In order to do so, some private companies enter into swaps (a derivative instrument) to economically convert their variable-rate borrowing to fixed-rate borrowing.

Current U.S. GAAP Topic 815, Derivatives and Hedging, requires that a company recognize all of its derivative instruments in its balance sheet as either assets or liabilities and measure them at fair value. To mitigate the income statement volatility of recording a swap at fair value, a company may elect "cash flow hedge" accounting if certain requirements are met.

Some private company stakeholders contend that because of limited resources and/or the complexity of understanding and applying hedge accounting, many private companies lack the expertise to comply with the requirements to qualify for cash flow hedge accounting. Therefore, they do not elect to apply hedge accounting, which results in income statement volatility. In addition, some stakeholders question the relevance and cost associated with determining and presenting the fair value of a swap that is entered into only for the purposes of economically converting variable-rate borrowing to fixed-rate borrowing.

PCC Issue No. 13-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps,* introduces two simpler approaches for private companies to account for certain types of interest rate swaps. In both approaches, the periodic income statement charge for interest would be similar to the amount that would result if the private company were to have entered into fixed-rate borrowing instead of variable-rate borrowing. The two approaches would apply to all private companies other than financial institutions.

The accounting alternatives in this proposal would provide two simpler approaches, the **combined instruments approach** and the **simplified hedge accounting approach,** to account for swaps that are entered into for the purposes of economically converting variable-rate borrowing to fixed-rate borrowing, if specific conditions are met.

- The **combined instruments approach** would provide companies an accounting alternative to account for a swap and a variable-rate borrowing as one combined financial instrument. In other words, the swap would not be recorded in the company's financial statements (except for the period-end accrual relating to the next swap settlement). This approach can be applied provided certain criteria are met. Those criteria include the swap term approximates the term of the borrowing and the swap becomes effective at the same time as the borrowing. If a company elects to adopt the combined instruments approach, that approach would be applicable to all of its swaps, whether entered into on or after the date of adoption or existing at that date, provided that the requirements of applying this approach otherwise are met. Under this approach the settlement value of the swap would be disclosed in the notes to the financial statements.
- The **simplified hedge accounting approach** would provide companies with a practical expedient to qualify for hedge accounting. The criteria to qualify for simplified hedge accounting are similar to the criteria proposed under the combined instruments approach; however, the term of the swap could be shorter than the term of the borrowing and the swap does not have to become effective at the same time as the borrowing. Under this approach, the swap and the related borrowing would continue to be accounted for as two separate financial instruments; however, no ineffectiveness would be assumed for qualifying swaps designated in a hedging relationship. Further, the designated swap may be recorded at settlement value in the company's financial statements instead of at fair value.

The proposed accounting alternatives would have the benefit of providing companies with two approaches that simplify the accounting for certain types of swaps that are entered into only for the purpose of economically converting variable-rate borrowing to fixed-rate borrowing—thus mitigating private company stakeholders' concerns about the costs, complexity, and relevance of applying current U.S. GAAP to swaps in those circumstances.

When Would the Accounting Alternatives Be Effective?

The PCC and the FASB will determine the effective date for the proposed requirements after they consider interested parties' feedback on the Exposure Drafts.

What Are the Next Steps in the Process?

For PCC Issue No. 13-01A and No.13-01B, the FASB directed the staff to conduct additional research during the comment period to assess the applicability of these proposals to public companies and not-for-profit organizations.

For PCC Issue No. 13-03, the Board directed the staff to conduct outreach through its normal channels, including advisory groups and other meetings in which the FASB participates, because the Board expects to consider other hedging issues in the near future.

Stakeholders are encouraged to review and provide feedback on the proposed Update by August 23, 2013.

Comments can be provided using the electronic feedback form available on the FASB website or emailed to director@fasb.org, referencing File Reference No. PCC-13-01A, No. PCC-13-01B, or No. PCC-13-03 by August 23, 2013. Written comments should be addressed to:

Technical Director
File Reference No. PCC-13-01A, No. PCC-13-01B, or No. PCC-13-03
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116

Following receipt of public comments, the PCC and the FASB will discuss the feedback at its September 30 to October 1, 2013 meeting. The PCC will then consider changes to the original proposals and take a final vote before submitting to the FASB for a final decision on endorsement.

More information on the proposals, including the Exposure Drafts and press release, are available on the FASB website and the PCC website.■

For more information about the project, please visit the FASB's website at www.fasb.org.

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