Private Company Council

PCC Issue No. 13-03

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

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Background

1. The Private Company Council (PCC) received input through outreach that private companies often find it difficult to obtain fixed-rate borrowing. Therefore, some private companies enter into receive-variable, pay-fixed interest rate swaps ("swap") to economically convert their variable-rate borrowings to fixed-rate borrowings. Under U.S. generally accepted accounting principles (GAAP), a swap is a derivative instrument. Topic 815, Derivatives and Hedging, requires that an entity recognize all of its derivative instruments on its balance sheet as either assets or liabilities and measure them at fair value. To mitigate the income statement volatility of recording a swap at fair value, Topic 815 permits an entity to elect "cash flow hedge" accounting if certain requirements under that Topic 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

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

hedge accounting, which results in income statement volatility. In addition, some stakeholders question the relevance and cost associated with determining and presenting the fair value of a swap that is entered into for the purposes of economically converting its variable-rate borrowing to fixed-rate borrowing.

2. At its May 7, 2013 meeting, the PCC reached a decision to allow private companies to use two simpler approaches to account for certain types of interest rate swaps that are intended to economically convert a variable-rate borrowing to a fixed-rate borrowing: (a) the combined instruments approach; and (b) the simplified hedge accounting approach, which addresses a potentially broader set of transactions than the combined instruments approach. On June 10, 2013, the Board endorsed the decisions of the PCC, leading to the issuance of a proposed Update, which was exposed for public comment on July 1, 2013. The Board invited all interested parties to comment on all matters in the proposed Update with a deadline to receive all comment letters by August 23, 2013.

3. Views expressed in response to the proposed Update varied depending on the approach in question (that is, the combined instruments approach or the simplified hedge accounting approach). As such, this Issue Summary Supplement has been separated into sections that reflect specific feedback received on each respective approach, where applicable. This Issue Supplement is organized as follows:

- Summary of Comment Letters Received (paragraphs 4-6)
- FASB Staff Analysis and Recommendations (paragraphs 7-86)
    - Overall Scope and Other Considerations (paragraphs 8-11)
    - Simplified Hedge Accounting (paragraphs 12-49)
        - Scope
        - Recognition and Measurement
        - Subsequent Measurement
        - Disclosure
        - Transition
    - Combined Instruments (paragraphs 50-80)
        - Scope
        - Disclosure
        - Transition

- Modified and/or Full Retrospective Approach (paragraphs 81-83)
- Effective Date and Early Adoption (paragraphs 84-86)

Summary of Comment Letters Received

4. The first question in the proposed Update asks respondents about their experience and background. The Board received 37 comment letters, which are summarized below by the type of respondent:

Constituency Type	Number of Comment Letters
Professional Accounting Associations (CLs #1, #4, #5, #7, #8, #12, #14, #21, #34, #35, #36)	11
Individuals (CL #2)	1
Seven Largest Accounting Firms (CLs #15, #17, #20, #23, #25, #27, #28)	7
All Other Accounting Firms (CLs #3, #6, #9, #13, #16, #26, #29, #31, #33)	9
Preparers (CLs #10, #11, #18, #22, #24, #30, #32, #37)	8
Corporate Hedging Advisors (CL #19)	1
Total	37

5. Comment letter respondents were asked to comment on several questions related to the proposed Update. For the purpose of the analysis below, the questions have been grouped into the following categories:

- General respondent information (Question 1)
- Scope (Questions 2-7)
- Recognition and Measurement (Questions 8, 10, 17)
- Disclosure (Questions 9, 11-12)
- Transition (Questions 13-16, 18-20)

6. Outreach was also performed to users of private company financial statements representing diverse user types with different background and sector specialties. User feedback is incorporated throughout this Issue Supplement.

FASB Staff Analysis and Recommendations

7. In the paragraphs that follow, the FASB staff analyzes the significant comments received and provides recommendations for the PCC.

Overall Scope and Other Considerations

8. The proposed amendments would apply to all entities, except publicly traded companies; not-for-profit entities (NFPs), as defined in the Master Glossary of the FASB Accounting Standards Codification; employee benefit plans within the scope of Topics 960 through 965 on plan accounting and financial institutions.[1] In Question 2, respondents were asked whether they agree that the scopes of both the combined instruments approach and the simplified hedge accounting approach should exclude financial institutions as described in paragraph 942-320-50-1. Most respondents (15 out of 20) indicated that they would exclude financial institutions from the scopes of both approaches because financial institutions deal with various financial assets and liabilities regularly, and users and regulators are familiar with accounting for financial instruments, including derivative instruments. Most respondents believe that it would be better to scope financial institutions out of the proposed Update because the effect of changing accounting for a financial institution's derivative instruments may result in confusion among the users of financial statements and unintended regulatory consequences. It is additionally important to note that no formal response to this question was received from financial institution preparers or users.

9. Five respondents (CLs #20, #21, #29, #30, and #35) believe that financial institutions should be included in the scope. Those respondents believe that if the financial institution qualifies for an alternative approach, it should be allowed to apply it just like any other entity. One respondent

[1] As described in paragraph 942-320-50-1, the term financial institutions includes banks, saving and loan associations, savings banks, credit unions, finance companies, and insurance entities.

(CL #20) added that the scope should primarily be based on the needs and preferences of the users of the financial statements, and, therefore, it would be preferable to allow the entities themselves to determine whether it is appropriate to apply either method given their specific facts and circumstances.

10. Most respondents believe that the proposed alternative should be extended to NFPs. Respondents expressed mixed views on whether the Board should extend the guidance to public business entities. The extension of the proposed alternatives to NFPs and public business entities will be analyzed by the Board separately.

FASB Staff Analysis and Recommendation

11. The staff notes that most respondents supported the scope of the proposed Update. The staff also received informal feedback from a financial institution preparer organization that believes that including financial institutions within the scope of the proposed Update may affect comparability with other entities that are not applying the proposals. In addition, the staff received informal feedback from a bank regulator that did not object to extending the simplified hedge accounting proposal to financial institutions because that proposal was viewed as a practical expedient to hedge accounting. Based on feedback received, the staff recommends the PCC reaffirm its previous decision regarding the scope of the proposed Update. However, the staff notes that the scope should be updated in order to align it with the definition of a public business entity, when completed.

PCC Question #1: Does the PCC wish to reaffirm the scope of the proposed alternative to be available to all entities, except public business entities (to be updated based on final definition), not-for-profit entities, employee benefit plans within the scope of Topics 960 through 965 on plan accounting, and financial institutions?

Simplified Hedge Accounting Approach

<u>Scope</u>

12. In response to Questions 4 and 5, constituents commented on whether they support the criteria as currently stated in the proposed Update. In addition to providing views on the specific

criteria, most respondents expressed an overall opinion on whether they agree or disagree with the simplified hedge accounting approach. Overall, 23 out of the 29 respondents to those questions either supported or conditionally supported the approach. Eight respondents did not directly address Questions 4 and 5 directly. Out of those eight respondents, two did not appear to support the proposed Update and six respondents appeared to generally support the proposed Update.

13. Out of the seven largest accounting firms, two supported the criteria unconditionally (CLs #15 and #25) and four expressed conditional support (CLs #17, #20, #27, and #28) while offering suggestions for potential modifications. One large accounting firm (CL #23) did not support issuing the proposed amendments in a final Update and stated that it would be more appropriate to re-evaluate the hedging requirements in Topic 815 for all companies. The nine other accounting firms responded unanimously in support of the simplified hedge accounting approach and several of those firms also provided recommendations to modify the approach criteria. Professional accounting organizations were overwhelmingly supportive of the criteria with unconditional support from six organizations (CLs #1, #4, #5, #12, #34, and #36) and conditional support from the remaining five respondents (CLs #7, #8, #14, #21, and #35). Three out of four preparers who responded did not support the simplified hedge accounting approach, of which two preparers (CLs #18 and #30) expressed disagreement with the approach due to their general preference for the combined instruments approach.

14. A few respondents suggested that the PCC and the Board consider alterations and/or clarifications to the simplified hedge accounting approach criteria. Those criteria from paragraph 815-20-25-131D of the proposed Update are as follows:

a. Both the variable rate on the swap and the borrowing are based on the same index and interest rate (for example, 1-month LIBOR).
b. The terms of the swap are typical (in other words, the swap is what is generally considered to be a "plain-vanilla" swap, even though that term is not defined), and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a comparable floor or cap.
c. The repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days.

d. The swap's fair value at inception (that is, at the time of application of the simplified hedge accounting approach) is at or near zero.
e. The swap is not a forward-starting swap.
f. The notional amount of the swap is equal to or less than the principal amount of the borrowing.
g. The term of the swap is equal to or less than the term of the borrowing.

15. Comments on the criteria have been grouped into three categories based on the most prevalent recommendations received in the comment letters: (A) forward starting swaps; (B) swap's fair value is zero or near zero; and (C) "you pick'em" debt.

(A) *Forward-Starting Swap*[2]

16. Six respondents (CLs #6, #7, #9, #20, #27, and #35) recommended removing the proposed Update's requirement in the criterion in paragraph 815-20-25-131D(e), which states that "the swap is not a forward-starting swap." Those respondents generally noted that forward-starting swaps are commonly utilized in practice. For example, Ernst & Young LLP (CL #27) stated the following:

> Companies often use a forward starting swap to hedge the forecasted interest payments that will occur when they extend borrowings under a facility that hasn't yet matured with a new facility. Bank facilities are typically extended up to two years before maturity to ensure the required financing isn't interrupted.

17. McGladrey LLP (CL #20) provided the following recommendation:

> As it pertains to both the combined instruments approach and the simplified hedge accounting approach, rather than stating that the swap cannot be a forward starting swap, we recommend this criterion for each approach be modified to state the swap can be forward starting as long as the debt is outstanding (rather than forecasted) at the inception of the swap. This modification would enable either approach to be employed on debt for example that has a fixed rate for a few years before converting to a variable rate.

FASB Staff Analysis and Recommendation

[2] A forward-starting interest rate swap takes the form of a "plain-vanilla" swap entered into at the current date, but with a deferred effective date. The key differentiator is the debt being hedged, that is, "plain-vanilla" swaps hedge existing debt and forward-starting swaps typically hedge expected debt issuances or a later deferred period, and not the initial period of an existing debt (for example, years three through five of a five-year debt for a swap entered into at the beginning of year one).

18. The staff recommends removing criterion (e) to allow the application of the simplified hedge accounting approach to forward-starting swaps. In reaching that conclusion, the staff notes it is not uncommon under current U.S. GAAP for a forecasted transaction involving a forward starting swap to be deemed perfectly effective using an approach such as the hypothetical-derivative method. The staff notes that, assuming an entity still meets the criteria in paragraph 815-20-25-131D(a), (b), (c), (d), (f), and (g), the removal of criterion (e) would provide private companies with a practical expedient to apply hedge accounting in arrangements that, under current U.S. GAAP, would likely be assessed to be highly effective. The staff recommends removing criterion (e) and clarifying in the basis for conclusions that cash flow hedges established through the use of a forward-starting swap may be permitted in applying the simplified hedge accounting approach if the occurrence of forecasted interest payments to be swapped is probable. Further, the staff recommends clarifying that when the forecasted interest payments are no longer probable of occurring, a cash flow hedging relationship would no longer qualify for the simplified hedge accounting approach.

19. Opponents of this view believe that removing criterion (e) would result in the application of the simplified hedge accounting approach to a broader set of hedging relationships than was originally intended. Further, opponents of this view maintain that private companies entering into forward-starting interest rate swaps already have the ability to elect hedge accounting and use other approaches in current U.S. GAAP, such as the hypothetical-derivative method. However, many private company stakeholders argue that those existing approaches are too complex or burdensome to apply.

PCC Question #2: Does the PCC agree with the staff recommendation to remove the criterion in paragraph 815-20-25-131D(e) and to add clarification in the basis for conclusions on the application of the simplified hedge accounting approach to forward-starting swaps?

(B) *Swap's Fair Value is at or near zero*

20. A few respondents commented that the Board should clarify the proposed requirement in the criterion in paragraph 815-20-25-131D(d), which states that the swap's fair value at inception

must be at or near zero. As drafted, the proposal is not clear as to whether "at or near zero" would include related transaction costs or initial up-front payments. Those respondents noted that several factors not specifically addressed in the proposed Update may influence the evaluation of the swap's fair value at the inception of a hedging relationship.

21. In order to clarify the "near zero" requirement, Ernst & Young LLP (CL#27) provided the following recommendation:

> We believe the Board should clarify the proposed requirement for both approaches that the swap's fair value at inception be at or near zero. As drafted, the proposal suggests that companies could apply the simplified approach to swaps that have been structured "off-market," (e.g., to include fees or to include an initial up-front payment that is "near zero").
>
> We do not support application of the simplified approach to "off-market" swaps or swaps with initial upfront payments due to "off-market" terms. We suggest the Board include in any final ASU language similar to the following excerpt from Statement 133 Implementation Issue No. E23:
>
>> The fair value of the swap may be other than zero at the inception of the hedging relationship only if the swap was entered into at the relationship's inception, the transaction price of the swap was zero in the entity's principal market (or most advantageous market), and the difference between transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction.

FASB Staff Analysis and Recommendation

22. The staff agrees with the views expressed above and does not support the application of the simplified hedge accounting approach to "off-market" swaps or swaps with initial upfront payments due to "off-market" terms. As such, the staff recommends an additional clarification within the basis for conclusions that will provide further guidance on the "at or near zero" requirements.

PCC Question #3: Does the PCC agree with the staff recommendation to clarify the meaning of "at or near zero" within the basis for conclusions of the final accounting standards update?

(C) *You Pick'em Debt*

23. Some respondents requested clarification on arrangements in which borrowers have the option to select the interest rate reset index (for example, LIBOR, Prime) and/or the reset frequency (for example, monthly, quarterly). Such variable-rate bank debt is commonly referred to as "you-pick'em" debt because of the flexibility provided to the borrower.

FASB Staff Analysis and Recommendation

24. The staff recommends that a further clarification should be added to the proposed Update to make clear that variable-rate debt with an option to select the interest rate index would not automatically disqualify a preparer from utilizing the simplified hedge accounting approach as long as both the benchmark rate on the swap and the benchmark rate on the borrowing are based on the same index and interest rate at the inception of a receive-variable, pay-fixed interest rate swap arrangement. If in subsequent reporting periods the borrower elects a change in the index and interest rate to a rate that is different from that in the swap contract, the relationship would no longer qualify for the simplified hedge accounting approach (see the criterion in paragraph 815-20-25-131D(a) in the proposed Update). At the time of disqualification, the entity would account for the swap in accordance with Topic 815 regarding the discontinuance of a cash flow hedge. Furthermore, the staff recommends including a reference to paragraph 815-30-40-5.[3]

PCC Question #4: Does the PCC agree with the staff's recommendation to clarify the guidance regarding "you pick'em" debt arrangements?

<u>Recognition and Measurement</u>

Documentation Requirements

[3] Paragraph 815-30-40-5 states that a "pattern of determining that hedged forecasted transactions probably will not occur would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions."

25. In Question 17, constituents were asked whether they agree with allowing private companies additional time to comply with formal hedge documentation requirements. Under the proposed Update, private companies would be allowed to complete the formal documentation within "a few weeks" after entering into a "plain vanilla" interest rate swap, instead of following the concurrent documentation requirements contained in paragraph 815-20-25-3.

26. The staff received 24 responses to Question 17 and virtually all of the respondents expressed support for allowing private companies additional time to comply with formal hedge documentation requirements. In supporting this documentation relief, most respondents corroborated the PCC's view that many private companies may lack the resources and/or knowledge to complete hedge documentation contemporaneously. Only one respondent (CL #25) out of the seven largest accounting firms supported retaining the contemporaneous documentation requirement for private companies because this respondent did not foresee significant time to document the election.

27. While respondents overwhelmingly supported the removal of the contemporaneous documentation requirement under current U.S. GAAP, several expressed concerns about the proposed requirement to complete the documentation within "a few weeks." Most who expressed that concern explained that completing documentation within "a few weeks" would be an administrative burden for some private companies. Those constituents are concerned that many private companies may only prepare U.S. GAAP financial statements once a year in connection with preparing for a year-end audit or review. Those constituents prefer allowing private companies to have the flexibility to complete the hedging documentation when their annual financial statements are prepared and issued for external distribution.

28. Addressing the administrative challenges that are faced by many private companies, RW Group LLC (CL #6) noted the following:

> A majority of non-public companies and not-for-profit entities have limited resources and most do not have internal accounting personnel that have a comprehensive understanding of accounting for derivatives. Entities generally go through a thorough evaluation of significant contracts such as long-term debt and

> swap agreements, but often do not document that thought process and final evaluation of the transaction. If it does happen, it occurs in anticipation of the auditor or even when the auditor arrives. For smaller entities that do not require an audit, the likelihood of the documentation occurring around the time of the transaction is even less likely to occur. If the Board holds onto the documentation requirement, those companies that are in the greatest need of relief will never actually be able to realize it, merely because they did not prepare certain documentation timely.

29. Sensiba San Filippo LLP (CL #33) noted similar practicability concerns:

> Private companies are frequently unaware of the accounting implications of interest rate swap transactions entered into until after consultation with their outside auditors or accountants, which may occur more than a few weeks after the transaction.

30. However, some other respondents questioned whether the additional time for completing the documentation would provide management with an opportunity to "look back" on the performance of the interest rate swap and then decide whether to apply hedge accounting under the proposed Update. For example, Deloitte & Touche LLP (CL #28) offered the following recommendation to clarify the documentation timeframe:

> We do not believe it is appropriate for an entity to apply hedge accounting until it has made an election to do so and concluded that the scope requirements have been met. Accordingly, an entity should at least have some form of documentation to that effect in place before it applies hedge accounting. Some entities may face practical challenges in compiling all of the required hedge documentation at the inception of a hedging relationship; therefore, we would not object if the final ASU permits such entities to finalize their hedge documentation within a short period after the inception of the hedging relationship. Though the Board is reluctant to establish "bright-line" guidance (as indicated in paragraph BC17), it should narrow the time frame during which this practical expedient may be applied or provide indicators of the reasonable boundaries of this range to prevent potential abuse (e.g., "within a week" instead of "within a few weeks").

FASB Staff Analysis and Recommendation

31. To address constituent concerns that private companies will not be able to complete documentation within "a few weeks" due to lack of resources and/or knowledge, the staff recommends providing one-time transition relief to private companies to allow for

documentation up until the time that the financial statements are available to be issued for the first fiscal year after the effective date of this proposed Update. That is, entities will be able to elect the simplified hedge accounting approach at the end of the first fiscal year covering the period in which they have adopted the proposed Update and would only be required to complete hedge documentation at such time. After that initial election to apply the simplified hedge accounting approach, however, the staff believes that those entities will have gained the experience and knowledge to prepare hedge documentation within "a few weeks." In addition, because the simplified hedge accounting approach is easier to apply and document (than existing methods in U.S. GAAP today), the staff does not anticipate that completing hedge documentation will require a significant amount of time. Based on that information, the staff does not recommend extending this one-time transition relief.

PCC Question #5: Does the PCC agree with the staff recommendation to provide one-time transition relief for the simplified hedge accounting approach documentation requirements?

Settlement Value

32. In Question 8, constituents were asked whether they agree that the primary difference between settlement value and fair value is that nonperformance risk of the swap counterparties is generally not considered in the settlement value. Overall, 19 out of the 24 respondents either agreed or conditionally agreed with that statement.

33. Although many respondents agreed that the primary difference between fair value and settlement value is that nonperformance risk is not considered in settlement value, several respondents raised practical concerns with using settlement value in the financial statements. Some respondents asked the Board to provide a specific definition of the term "settlement value" in the Master Glossary. Those respondents noted that the settlement value amount may vary significantly from the swap's termination value and may also differ due to diversity in practice among swap counterparties that may provide settlement value information.

34. For example, PricewaterhouseCoopers LLP (CL #25) proposed defining settlement value as follows:

> We are sympathetic to the burdens of determining fair value for interest rate swaps, and for practical reasons would be supportive of providing some relief to private companies. However, the settlement value described in the proposed standard does not appear to be a viable approach. It is our understanding that determining a true settlement value (i.e., that is the determination of the amount to be paid or received upon early settlement or the unwinding of a derivative instrument) involves more complexity than simply removing the non-performance risk of the swap counterparties from the present value of the predicted future settlements, as suggested in the proposed standard. We understand that counterparties will likely require compensation for other related risks, such as the cost of unwinding its own hedge position and the related out-of-pocket costs to analyze and transact the offsetting positions. For these reasons, we believe that the settlement value described in the proposed standard does not represent the price at which the instrument would be unwound, nor do we believe that this amount could be readily obtained or verified by reference to other sources. We propose instead that "settlement value" be replaced with the discounted present value of the remaining estimated cash flows under the agreement using mid-market pricing for creditworthy counterparties. This amount would likely be more effective at arriving at the goals of the standard than would the current proposal. Furthermore, we believe that this amount should be readily determinable by private companies or easily obtainable from outside sources.

35. Other respondents noted that there may be situations in which a significant difference between settlement value and fair value results from factors other than nonperformance risk, and, therefore, settlement value may provide private company financial statement users with inadequate information. For example, KPMG LLP (CL #23) noted the following:

> Disclosure of the swap's settlement value may not adequately provide an indication to financial statement users of the future cash flows of the interest rate swap. For example, if the swap counterparty suffers a significant credit deterioration it may not be able to transact at settlement value. Fair value is an important consideration for entities that enter into derivatives, whether for trading or hedging purposes, because it is important to understanding the particular risks of the instrument, such as credit, liquidity, and interest rate risks. If settlement value is used to measure the derivatives, there is a risk that entities will not understand the fair value measurements of their derivatives and the corresponding risks associated with those transactions. In addition, the use of settlement value to measure interest rate swaps under the simplified hedge accounting method could mislead users of financial statements due to the potentially significant risks (credit

> of both parties and liquidity risks) associated with interest rate swaps that would not be considered in that value.

36. In Question 10, constituents were asked whether the costs of obtaining and auditing settlement value would be significantly less than fair value. Out of 26 respondents to this question, 20 agreed that the use of settlement value would reduce financial reporting costs compared with fair value. Of the 20 respondents who agreed that using settlement value would reduce costs, five respondents (CLs #5, #8, #14, #17, and #26) qualified their answer by noting that they expect a reduction in the costs of obtaining settlement value but not a reduction in the costs to audit that amount because auditors are likely to apply similar procedures in order to verify the inputs and calculations. Among the remaining six respondents to this question, five respondents (CLs #1, #9, #23, #25, and #29) disagreed with the view that using settlement value would reduce costs, and one respondent (CL #27) concluded that such an assessment cannot be made at this time.

FASB Staff Analysis and Recommendation

37. The staff notes that there appears to be general agreement that the primary difference between settlement value and fair value is that settlement value is not adjusted for nonperformance risk. Based on comment letters received, respondents raised several practical concerns related to the determination of the settlement value amount, such as the potential for transaction and termination costs that may be unobservable to the borrower. Due to those various practical considerations, the staff believes that it would be difficult to achieve agreement on a precise (that is, Master Glossary) definition of the term "settlement value." Still, the staff believes that additional guidance should be provided on the implementation of the "settlement value" concept. That guidance would provide further clarification on practical considerations related to determining the settlement value amount. Specifically, the staff recommends that the proposed Update include the following implementation guidance:

> The settlement value amount should approximate the amount the borrower would expect to pay (or receive) in order to terminate the interest rate swap as of the reporting date, without considering nonperformance risk. One acceptable approach for estimating the swap's settlement value would be to perform a discounted present value calculation of

the swap's remaining estimated cash flows using mid-market pricing for creditworthy counterparties.

38. Based on feedback received, the staff believes that the use of settlement value is a cost effective practical expedient that will provide users of private company financial statements with relevant information on interest rate swaps applying the simplified hedge accounting approach.

PCC Question #6: Does the PCC agree with the staff's recommendation to add implementation guidance regarding "settlement value"?

Subsequent Measurement

39. A few respondents expressed concern about the use of settlement value in situations in which the swap counterparty's credit position deteriorates subsequent to the inception of the swap arrangement. The use of settlement value, for example, could significantly overstate a swap asset when the borrower expects to receive payments from a swap counterparty with high credit risk.

40. To address the risk of counterparty default and the potential for adverse developments during the term of a swap arrangement, Deloitte & Touche LLP (CL #28) recommended that the proposed Update should emphasize that to initially (and subsequently) qualify for the simplified hedge accounting approach, a private company would have to satisfy the requirements contained in Topic 815 regarding the consideration of counterparty credit risk and the possibility of default by the counterparty to a hedging derivative.

FASB Staff Analysis and Recommendation

41. The staff notes that a significant adverse development regarding the risk of counterparty default is already addressed in current U.S. GAAP under Topic 815. Nevertheless, in order to address constituent concerns, the staff recommends that the proposed Update include a clarification in the basis for conclusions that, consistent with the requirements in paragraph 815-20-35-15, entities applying the simplified hedge accounting approach would be required to monitor the counterparty's performance on an ongoing basis. If the evaluation concludes that the likelihood that the counterparty will not default ceases to be probable, then the entity would not

be able to conclude that the hedging relationship in a cash flow hedge is expected to be highly effective. As a result, the simplified hedge accounting approach would no longer apply and the use of settlement value would not be permitted.

PCC Question #7: Does the PCC agree with adding a reference to the requirements in paragraph 815-20-35-15 when applying the simplified hedge accounting approach?

Disclosure

42. In Question 12, constituents were asked whether they support retaining current U.S. GAAP disclosures, including those under Topic 815 and Topic 820, Fair Value Measurement. Most respondents (18 out of 23) either supported or conditionally supported retaining the current requirements.

43. However, several respondents expressed concern that the disclosure requirements in Topic 820 regarding fair value may be difficult to apply to settlement value. Specifically, some expressed concern that it will be difficult to make the "leveling" determination required by Topic 820 when substituting settlement value for fair value. In addition, a few of those respondents recommended providing a clear indication that settlement value has been substituted for fair value. The Financial Reporting Executive Committee of the AICPA (CL #35), for example, recommended the following:

> We agree that settlement value may be substituted for fair value when the simplified hedge accounting approach is applied but that there should be disclosures to indicate that settlement value has been substituted. The final standard should be clear that settlement value is a different measurement method and not intended to represent fair value to avoid any confusion or unintended consequences.

44. One respondent (CL #34) recommended scaling back the disclosure requirements. That respondent believes that the proposed combined instruments approach disclosures would also be suitable for entities applying the simplified hedge accounting approach.

FASB Staff Analysis and Recommendation

45. The staff recommends retaining the current U.S. GAAP disclosure requirements in the proposed Update, including those under Topics 815 and 820, because private companies utilizing the simplified hedge accounting approach will be applying the core provisions of those standards. In addition, the staff recommends revising guidance contained in paragraph 815-10-50-3 of the proposed Update to require disclosure of the number of swaps being recorded at settlement value.

PCC Question #8: Does the PCC agree with the staff's recommendation to revise paragraph 815-10-50-3 of the proposed Update to require the disclosure of the number of swaps being recorded at settlement value?

<u>Transition</u>

Accounting Policy Election and Election upon Adoption

46. In Question 15, respondents were asked whether they agree that the simplified hedge accounting approach could be elected for any qualifying swaps existing at the date of adoption or entered into on or after the adoption date. Of the 21 respondents who answered that question, 17 agreed that the simplified hedge accounting approach could be elected for any qualifying swap.

47. In Question 16, respondents were asked whether they agree that the election to apply the simplified hedge accounting approach to an existing qualifying swap must be made upon adoption of the amendments in this proposed Update. Most of the respondents (16 out of 20) agreed that this would be appropriate.

FASB Staff Analysis and Recommendation

48. An entity within the scope of the proposed Update could elect to apply the simplified hedge accounting approach to existing swaps at the date of adoption provided that the requirements for applying that approach otherwise are met. In determining whether an existing swap otherwise would meet all of the requirements for applying the simplified hedge accounting approach, the criterion that the swap's fair value at the time of application of this approach be at or near zero does not need to be considered. Instead, as long as the swap's fair value was at or near zero at the

time the swap was entered into (or acquired) by the entity, the swap would qualify for the simplified hedge accounting approach.

49. The staff believes that the proposed transition approach addresses the concerns regarding the accounting for those swaps and the related volatility in the income statement in the absence of applying hedge accounting. Furthermore, the majority of respondents indicated support for the proposed transition method. As such, the staff recommends that the PCC reaffirm its decision that the simplified hedge accounting approach could be elected for existing swaps at the date of adoption provided that the requirements of applying this approach otherwise are met.

PCC Question #9: Does the PCC agree with the staff's recommendation to reaffirm its previous decision that the simplified hedge accounting approach could be elected for existing swaps at the date of adoption provided that the requirements of applying this approach otherwise are met?

Combined Instruments Approach

<u>Scope</u>

50. In Questions 4 and 5 of the proposed Update, constituents were asked to comment on whether they support the criteria as stated to qualify for the combined instruments approach. In addition to providing views on the specific criteria, several respondents expressed an overall opinion on whether they agree or disagree with the basis supporting the combined instruments approach. Of the seven largest accounting firms that responded, only one large accounting firm (CL #20) expressed support, while the other six (CLs #15, #17, #23, #25, #27, and #28) opposed the combined instruments approach due to a concern that applying this alternative will result in a fundamentally different conceptual basis for preparing financial statements of private companies as compared to current U.S. GAAP. The primary concern expressed by those respondents was the fact that the combined instruments approach reintroduces the concept of synthetic instrument accounting,[4] which was rejected by the Board at the time it issued Statement No. 133,

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

Accounting for Derivative Instruments and Hedging Activities. Specifically, respondents pointed to paragraph 350 of Statement 133, which states:

> The Board decided not to allow synthetic instrument accounting because to do so would be inconsistent with (a) the fundamental decision to report all derivatives in the financial statements, (b) the fundamental decision to measure all derivatives at fair value, (c) the Board's objective to increase the transparency of derivatives and derivative activities, and (d) the Board's objective of providing consistent accounting for all derivative instruments and for all hedging strategies. Synthetic instrument accounting also is not conceptually defensible because it results in netting assets against liabilities (or vice versa) for no reason other than an asserted "connection" between the netted items.

51. The one corporate hedge accounting advisor respondent, Chatham Financial (CL #19), also did not support the combined instruments approach and provided the following explanation:

> The proposed combined instruments approach reverts back to synthetic instrument accounting, which obscures the use of derivatives, results in the combination of assets and liabilities that don't necessarily have any contractual relation to one another, and, under the proposed guidance, relegates potentially significant information to disclosures only. While the combined instruments approach would provide the benefit of simplified accounting, we believe reintroducing synthetic instrument accounting is too risky and is a change that is too fundamentally different from the current framework used by the FASB. Further, private companies would still be required to obtain the settlement value of the interest rate swap for disclosures under this approach.

52. In addition to concerns about synthetic accounting, respondents who opposed the combined instruments approach also noted that giving private companies a different approach to account for derivatives from the hedging approaches that are permitted under current U.S. GAAP (that is, the shortcut, the simplified hedge accounting, and the long haul methods) may add unintended complexity for preparers and also lead to comparability issues for users of private company financial statements.

53. Of the nine other accounting firms that responded, seven commented on the combined instruments approach criteria. Of those seven firms, five firms (CLs #3, #6, #9, #29, and #33) expressed conditional support for the approach, one firm (CL #26) expressed unconditional

support, and one firm (CL #31) did not support the approach. Of the four preparers who responded to this question, three (CLs #10, #18, and #22) supported the combined instruments approach, and one respondent (CL #37) did not support the approach. Professional accounting organizations were overwhelmingly supportive of the combined instruments approach. Of nine professional accounting organizations that responded, four (CLs #1, #4, #5, and #34) expressed support, four (CLs #7, #8, #14, and #21) expressed conditional support, and one (CL #35) did not support the approach.

54. In total, 19 out of 29 respondents either supported or conditionally supported the combined instruments approach. Eight respondents did not address Questions 4 and 5 directly. Of those eight respondents, two did not appear to support the proposed Update and six respondents appear to generally support the proposed Update.

FASB Staff Analysis and Recommendation

55. Due to strong opposition regarding the theoretical concepts underpinning the combined instruments approach, the staff has presented the following alternative views and related question for the PCC to consider:

View A – Do not reaffirm decisions on combined instruments

Proponents of View A believe that the simplified hedge accounting approach is sufficient to meet the PCC's goal of providing relevant information to private company financial statement users and in reducing the cost and complexity of applying hedge accounting for private companies. Further, the combined instruments approach does not provide enough incremental benefit in terms of providing relief to private companies to justify an exception from the fundamental concepts in Topic 815. Therefore, in the event that the simplified hedge accounting approach is adopted as an accounting alternative, the combined instruments approach should not be included in the proposed Update.

View B – Reaffirm previous decisions on combined instruments

Based on the differences in user needs and preparer resources as described in the Private Company Decision Making Framework between private companies and public companies, proponents of View B believe that private companies should be provided with an exception to the fundamental decision in paragraph 815-10-10-1 that derivatives should be recognized in the financial statements. Regardless of whether or not the simplified hedge accounting approach is adopted as an accounting alternative, the combined instruments approach should also be reaffirmed by the PCC because that approach continues to provide relevant information to private company financial statement users while reducing the cost and complexity of providing that information.

56. The staff has mixed views on the combined instruments approach. On the one hand, as many constituents noted, the approach is conceptually unsound due to the "off balance sheet" treatment for the swap asset or liability. That "off balance sheet" treatment may result in unanticipated balance sheet and income statement volatility if the debt is repaid prior to maturity and the swap is not terminated at the same time or if there is an early termination of the swap and the debt is still outstanding. On the other hand, the approach would only be applied under a narrow set of circumstances covering "plain vanilla" swap transactions under which the overall economics are more akin to a fixed-rate borrowing. Furthermore, the staff believes that portraying a single combined instrument is supportable when considering the unique characteristics of private companies as described in the Private Company Decision-Making Framework. Users of private company financial statements may have greater access to management and may focus on adjusted EBITDA, rather than Net Income, as a key operating metric. In addition, preparers of private company financial statements generally do not have the same level of accounting resources as public companies. In considering those conflicting viewpoints, the staff believes that the potential benefit to private companies in terms of accounting simplification and potential cost reductions ultimately outweighs the detriment of the conceptual flaws, such as "off balance sheet" treatment of the swap and the potential for unanticipated volatility. Based on that realization, the staff recommends the PCC reaffirm its decision to provide a combined instruments approach.

PCC Question #10: Does the PCC wish to reaffirm its decision to provide a combined instruments approach to account for swaps that economically convert their variable-rate borrowing to fixed-rate borrowing?

Management Intent

57. *(The following discussion on the combined instruments approach is only relevant if the PCC reaffirms its previous decisions in the proposed Update on the combined instruments approach.)* In Question 6, constituents were asked whether the combined instruments approach should include additional criteria about management's intent to hold the swap to maturity (unless the borrowing is prepaid). Of the 24 respondents who answered this question, nine agreed that it would be appropriate to include additional criteria about management's intent to hold the swap to maturity. Those respondents believe that adding criteria about management's intent to hold the swap until maturity would be consistent with the principles of the combined instruments approach because that approach records the swap and variable rate debt as a single synthetic fixed-rate instrument. If the swap is settled before maturity, there would be a gain or loss on the settlement and the borrowing would revert from fixed to variable rate, which may be confusing to users of financial statements. Therefore, requiring management to state its intent to hold the swap to maturity would limit the ability of any entity to inappropriately elect this approach. Some respondents expressed concern that any management-intent criteria would also need to address the notion of "tainting" (for example, similar to guidelines in Section 320-10-35) if management subsequently terminates a swap accounted for under the combined instruments approach. Deloitte & Touche LLP (CL #28) explained its view as follows:

> If the Board adds this requirement, it should also address in the final ASU the notion of "tainting" (i.e., the Board should address whether management's decision to subsequently terminate a swap accounted for under the combined instruments approach before the maturity (or prepayment) of the borrowing would call into question management's intent to hold other swaps accounted for under the combined instruments approach and whether management would have to discontinue the use of the combined instruments approach for all qualifying swaps for a specified period of time).

58. The 15 respondents who disagreed with additional criteria about management's intent believe that such criteria would add little value because it is already implied by meeting the criteria to qualify for the combined instruments approach. Also, the respondents mentioned that such criteria would be an easy hurdle to overcome because management can always say that its original intent was to hold the swap to maturity. Other respondents noted that additional criteria

related to management intent would only cause confusion because it is difficult to distinguish between management not having the original intent to hold the swap to maturity and management reacting to actual or perceived economic events. Thus, such criteria would be difficult to operationalize from an audit perspective and would be inconsistent with the simplification that the PCC is trying to achieve.

FASB Staff Analysis and Recommendation

59. The staff agrees with the majority of respondents that additional criteria surrounding management's intent is not necessary for inclusion in the proposed Update. The staff notes that the overwhelming majority of private entities that would qualify for the combined instruments approach would likely be doing so to convert variable-rate debt to fixed-rate debt, so management's intent to hold the swap to maturity is implicit in the arrangement. Furthermore, the operational difficulties of auditing management intent and evaluating potential "tainting" would be overly burdensome for many private companies. Therefore, the staff does not recommend including additional criteria related to management's intent in the proposed Update.

PCC Question #11: Does the PCC agree with the staff recommendation to reaffirm its decision to exclude management's intent as a criterion in the combined instruments approach?

Adverse Developments/Credit Risk of the Counterparty

60. In Question 7, constituents were asked whether the combined instruments approach should have a requirement that there have been no adverse developments regarding the risk of counterparty default such that the swap is not expected to be effective in economically converting variable-rate borrowing to fixed-rate borrowing. Of the 24 respondents who answered this question, 10 agreed that such a requirement should be added. Those respondents believe that a hedging strategy can only be effective if the derivative counterparty is expected to perform. If there is a subsequent adverse development at the counterparty, the basis for applying hedge accounting may be undermined and the continuation of hedge accounting may no longer be acceptable. Therefore, those respondents believe that it would be appropriate to have a continuing assessment of adverse developments regarding the risk of counterparty default,

similar to current requirements under Topic 815 to qualify for hedge accounting. One respondent, Plante & Moran PLLC (CL#29), explained:

> In the case of a fixed-rate debt instrument, there is little to no risk related to counterparty default; the default risk is borne by the lender almost exclusively. While an interest rate swap eligible for the combined instruments approach effectively results in the borrower having a fixed rate debt instrument, the borrower also assumes some risk of counterparty default, which is not present in a true fixed-rate borrowing arrangement. Because counterparty default can eliminate the benefit obtained from the swap arrangement, we believe it should be included as a requirement to qualification for the combined instruments approach.

61. The 14 respondents who disagreed with including a requirement that there have been no adverse developments regarding the risk of counterparty default believe that the costs of complying with that requirement would outweigh its benefits. The respondents mentioned that many private entities do not have the resources to assess the credit quality of the counterparty in an effective manner. Also, one respondent stated that "plain vanilla" swap markets are sufficiently well developed such that other parties are likely to assume counterparty swaps in the event of the insolvency of the counterparty. Furthermore, a number of respondents noted that this analysis is inherent in any audit or review engagement as part of the assessment of potential contingencies (that is, Topic 450). Therefore, an additional requirement would be unnecessary. For example, Moss Adams LLP (CL #9) stated the following:

> We do not believe there should be such a requirement for the combined instruments approach. We believe the guidance in ASC 450, Contingencies, could be followed. Entities would consider whether the counter party default is remote, reasonably possible or probable in determining whether to record a gain or loss and the extent of disclosure.

FASB Staff Analysis and Recommendation

62. The staff recommends adding a disclosure requirement related to adverse developments in the risk of counterparty default. Specifically, if payments from the counterparty on the swap are no longer probable, the staff recommends disclosing that fact along with a disclosure of the fact that the future periodic income statement charge for interest expense may no longer be

equivalent to the amount recorded for a fixed-rate borrowing. Refer to paragraphs 71 and 72 below for a detailed discussion of this recommendation.

Other combined instruments criteria

63. Of the respondents who supported the combined instruments approach, several suggested modifications to the combined instruments approach criteria. Those criteria from paragraph 815-50-15-2 of the proposed Update are as follows:

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

64. Those respondents suggesting modifications to the criteria generally believe that the criteria in the proposed Update are overly restrictive. Suggestions to relax the combined instruments approach criteria included the following:

a. Removing the criterion in paragraph 815-50-15-2(e), which states "the swap is not a forward-starting swap"
b. Modifying the criterion in paragraph 815-50-15-2(f) to allow for situations in which the notional amount of the swap is greater than the principal amount of the borrowing
c. Modifying the criterion in paragraph 815-50-15-2(g) to allow for situations in which the swap term is shorter than the term of the borrowing
d. Removing the criterion in paragraph 815-50-15-2(h), which states that the swap must be "effective at the same time as the borrowing or within a few days."

FASB Staff Analysis and Recommendation

65. The staff notes that amending those criteria would go against the original intent of the combined instruments approach, which was to apply an alternative accounting model to circumstances in which a variable-rate borrowing has been economically converted into a fixed-rate borrowing through the use of an interest rate swap. As such, the staff does not recommend removing criterion (e). Furthermore, the staff notes that the recommendation contained in paragraph 18 above for the simplified hedge accounting approach may provide flexibility for arrangements that involve forward starting swaps. The staff also does not recommend allowing for situations in which the notional amount of the swap is greater than the principal amount of the borrowing. The staff acknowledges that situations in which the debt is amortized and the swap is not may lead to circumstances under which the swap is in an "overhedge" position during the term of the debt. The staff believes, however, that allowing for arrangements with forward-starting swaps and "overhedge" swap positions would introduce unnecessary complexity into the application of the combined instruments approach and potentially result in unintended consequences.

66. In considering whether to allow for situations in which the swap term is shorter than the borrowing term, the staff noted that it may also be necessary to remove criterion (h). Those modifications would eliminate the significant differences between the combined instruments and simplified hedge accounting approach criteria. The alternate views on those proposed modifications are summarized as follows:

View A – Modify criterion (g) and remove criterion (h)

Proponents of View A believe that if the swap's term is for an intermediate or end period, such as only for years two and three or only for years four and five of a five-year debt, the result would be economically converting a *portion* of the variable-rate debt to fixed-rate debt. They do not believe that the intent to economically enter into a fixed-rate debt should necessarily be demonstrated at the commencement of the debt. Instead, they argue that more flexibility should be provided such that if the private company decides at a later date to enter into a swap to economically convert all or a portion of the remaining term of the variable-rate debt into a fixed-rate debt, application of the combined instruments approach should be allowed from the effective date of such a swap. Proponents indicate that it is not uncommon for a private company that has a comparatively longer-term variable debt to enter into a swap for the initial term, for example the first 2 years of a 10-year debt, and then, in the third year, to enter into another swap for economically converting all or a portion of the remaining term of that debt into a fixed-rate debt. Proponents also indicate that the market liquidity and availability of short-term interest rate swaps is generally greater than long-term swaps; therefore, in some circumstances, a more competitive swap rate is obtained when a series of short-term swaps are entered into instead of one long-term swap.

View B – Modify criterion (g) and retain criterion (h)

Proponents of View B do not agree with removing the requirement that the swap be effective at the same time as the debt. They observe that modification to criterion (g) would not prohibit application of the combined instruments approach when swapping an initial period, for example, the first three years of a five-year debt rather than an intermediate or end period of that debt. Proponents agree that this is appropriate because when swapping an initial period, the intent to economically enter into a fixed-rate debt is demonstrated at the commencement of the debt and not at a later period.

View C – Reject modification of criterion (g) and retain criterion (h)

Proponents of View C believe that the combined instruments approach should only be applied in circumstances in which a variable-rate borrowing has been economically converted into a fixed-rate borrowing through the use of an interest rate swap. They believe that criteria (g) and (h) are critical in determining whether such an arrangement is economically equivalent or similar to fixed-rate debt. They also argue that criteria (g) and (h) were the key differences between the approaches exposed in the proposed Update and, for respondents who generally supported the combined instruments approach, most agreed with the differences in criteria for applying the two approaches.

67. The staff recommends View C. That is, the staff does not recommend modifying criterion (g) or removing criterion (h) because those modifications might lead to the combined

instruments approach being applied to a broader set of circumstances than was originally intended. In reaching that conclusion, the staff notes that obtaining a fixed interest rate for a portion of the debt term, rather than for the entire term, is economically different from entering into fixed-rate debt. Furthermore, the staff believes that the simplified hedge accounting approach would provide sufficient relief for swap arrangements that do not meet criteria (g) and (h).

PCC Question #12: Does the PCC agree with the staff recommendation to reaffirm its previous decisions regarding the criteria in paragraph 815-50-15-2?

Disclosure

68. In Question 11, constituents were asked whether they support the following disclosure items for the combined instruments approach:

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

69. Most respondents who supported the combined instruments approach also supported the disclosure items listed above. Some respondents suggest removing the requirement to disclose "valuation methods and assumptions" utilized to determine settlement value. Those respondents noted that, in situations in which settlement value is obtained directly from the swap counterparty, the valuation method and assumptions may not be readily obtainable. For example, BDO USA, LLP (CL #15) stated the following:

> In most cases, the settlement amount is based on a statement from the counterparty (e.g., a bank statement). Requiring private companies to "look through" to the underlying components of the swap value could pose significant

costs. We question the usefulness of disclosing these figures since most of the informational value associated with item a.) is the amount of a hypothetical settlement, not the build-up of that figure.

FASB Staff Analysis and Recommendation

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

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

PCC Question #13: Does the PCC agree with the staff recommendation to revise the guidance in paragraph 815-50-50-1(b)?

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

View A – Discontinuance of the combined instruments approach

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

View B – Disclosure of counterparty default risk

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

72. For the reasons stated above, the staff recommends View B. The staff believes that this recommendation is consistent with the Private Company Decision-Making Framework because the proposed disclosure would provide private company financial statement users with relevant information that future income statement charges for interest expense may no longer approximate a fixed-rate borrowing and does so at reasonable level of cost and complexity.

PCC Question #14: Does the PCC agree with the staff recommendation to add a disclosure for adverse developments regarding the risk of counterparty default (View B)?

PCC Question #15: Does the PCC agree with the staff recommendation to reaffirm the remaining disclosure items for the combined instruments approach?

Transition

Accounting Policy Election and Election upon Adoption

73. In Question 13, respondents were asked whether the combined instruments approach should be applied as an entity-wide accounting policy election and, if a policy is elected, whether it should be applicable for all qualifying swaps either existing at that date or entered into on or after the date of adoption. Of the 23 respondents who answered this question, 15 respondents agreed that the combined instruments approach should be applied as an entity-wide accounting policy election and be applicable for all qualifying swaps. One respondent (CL #19) agreed that the combined instruments approach should be an entity-wide accounting policy election but prefers the approach be applicable on a prospective basis only (that is, for all qualifying swaps entered into on or after the date of adoption).

74. The seven respondents who disagreed with providing an entity-wide accounting policy election for the combined instruments approach believe that the approach should be applied on an instrument-by-instrument basis. Those respondents noted that this would align the accounting election with the evaluation criteria, which requires each instrument to be evaluated separately. Also, the respondents noted that most entities would have the ability to easily modify the terms of a swap if they did not want to use the combined instruments approach. Therefore, this entity-wide election could result in entities structuring their derivative contracts to avoid applying the combined instruments approach altogether in certain circumstances. One respondent (CL #15) noted that it would generally be preferable to recognize the interest rate swap in the financial statements and recommended leaving that possibility open even if the combined instruments approach is used initially.

75. In Question 14, respondents were asked whether they agree that the entity-wide accounting policy election to apply the combined instruments approach must be made upon adoption of the amendments in the proposed Update or, for entities that do not have existing eligible swaps, within a few weeks after the entity enters into its first transaction that is eligible for the

accounting policy election. Nine respondents (out of the 21 respondents who answered this question) generally agreed that the entity-wide accounting policy election must be made upon adoption or, for entities that do not have existing eligible swaps, within a few weeks after the entity enters into its first transaction that is eligible for the accounting policy election. One respondent (CL #33) agreed that the policy election must be made upon adoption for existing swaps but disagreed with requiring the election to be made within a few weeks of entering a new swap transaction. That respondent mentioned that most private companies do not evaluate their accounting policies until after a consultation with their outside auditors, which may occur more than a few weeks after the transaction.

76. Eleven respondents stated that they disagree with the proposal in Question 14. Many of those respondents mentioned that, although they appreciate the flexibility that this proposal attempts to provide, they believe that the requirement would be overly restrictive for many private companies. They indicated that, practically speaking, some entities may remain unaware of the new guidance, its effective date, or the need to make an accounting policy election until the year-end audit. Four respondents (CLs #8, #9, #20, and #34) stated that expanding the accounting policy election timeframe to the point in time when the first financial statements are available to be issued for the fiscal year subsequent to the issuance of the proposed Update would resolve that issue.

FASB Staff Analysis and Recommendation

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

78. The staff also agrees with the majority of respondents that the entity-wide accounting policy election to apply the combined instruments approach must be made upon adoption of the amendments in the proposed Update.

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

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

80. The staff agrees with concerns expressed by several respondents that within "a few weeks after the entity enters into its first transaction" may not provide sufficient time for many private companies to assess the appropriate entity-wide accounting policy election. Those constituents noted that many private companies only evaluate accounting policies once a year in connection with preparing for a year-end audit or review. Further, the within "a few weeks" requirement may preclude combined instruments approach accounting for many private companies that would otherwise benefit from the application. As such, the staff believes that private companies that do not have existing eligible swaps on the effective date of this proposed Update should be provided with additional relief. Specifically, the staff recommends the following revision to the guidance in the proposed Update (added text is <u>underlined</u> and deleted text is ~~struck out~~):

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

PCC Question #16: Does the PCC agree with the staff recommendation detailed in paragraph 80 to revise the guidance for entities that do not have existing eligible swaps upon the effective date of the proposed Update?

Transition—Modified and/or Full Retrospective Approach

81. In Question 18, respondents were asked whether they believe that entities within the scope of this proposed Update should be provided with an option to apply the amendments using either (a) a modified retrospective approach in which the opening balances of the current period

presented would be adjusted to reflect application of the proposed amendments, or (b) a full retrospective approach in which financial statements for each individual prior period presented and the opening balances of the earliest period presented would be adjusted to reflect the period-specific effects of applying the proposed amendments. Of the 22 respondents who answered this question, 16 agreed that this option would be appropriate because it would allow an entity to make a cost-benefit decision as to whether its financial statement users would sufficiently benefit from the enhanced comparability that a full retrospective approach would provide.

82. The six respondents who disagreed with providing an option to apply either a modified retrospective or a full retrospective approach expressed concern that this option would decrease comparability across firms applying the amendments. Those respondents preferred one transition method, which is as follows:

a. Two respondents (CLs #1 and #21) stated that only the full retrospective approach should be allowed. Those respondents believe that the value added by having fully comparative financial statements would outweigh the minimal costs of performing full retrospective application because most entities that qualify for the accounting treatment will only have a few swaps and the information is readily available.
b. Three respondents (CLs #19, #27, and #28) believe that those amendments should only be applied prospectively for qualifying new or re-designated hedging relationships because it would be more consistent with historical practice and it would not be appropriate for entities to retrospectively apply the provisions of the proposed Update with the benefit of hindsight.
c. One respondent (CL #26) stated that only the modified retrospective approach should be allowed because it would provide sufficient transparency to financial statement readers while promoting comparability across firms and respecting the cost-benefit equation of obtaining and compiling the information.

FASB Staff Analysis and Recommendation

83. The staff agrees with the majority of respondents that entities within the scope of this proposed Update should be provided with an option to apply the amendments using either (a) the

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

PCC Question #17: Does the PCC agree with the staff recommendation to reaffirm its previous decision on transition to allow an option to apply either the modified retrospective approach or the full retrospective approach?

Effective Date and Early Adoption

84. In Question 20, constituents were asked how much time would be needed to implement the proposed amendments. Of the 21 respondents who answered this question, 12 respondents did not believe that significant time would be necessary because the information to apply either the modified or full retrospective approach would be known or easily available and the accounting change would not result in any significant systems or implementation issues. However, nine respondents believe that private companies would need additional time to implement the amendments. Those respondents believe that a delayed effective date would allow entities more time to become aware of the new guidance, understand it, and make decisions appropriately. One respondent (CL #33) added that allowing additional time for private companies to understand the implications of those changes is arguably even more important for this proposed Update because there will not be access to public company financial statements for reference examples of disclosures and adoption presentation. Of the nine respondents who stated additional time was necessary, seven respondents stated that an effective date of one year after issuance would allow entities sufficient time to adopt the provisions of the proposed Update appropriately.

85. In Question 19, constituents were asked whether early adoption of the proposed Update should be allowed. Respondents unanimously agreed that early adoption should be permitted.

FASB Staff Analysis and Recommendation

86. Based on respondent feedback, the staff recommends that private companies should be able to apply the alternative, if they elect to do so, for "plain vanilla" swaps existing as of the beginning of the period of adoption and for "plain vanilla" swaps entered into during fiscal years, and interim periods within those years, beginning after December 15, 2014, and that early application should be permitted. If this proposal were to be issued before the end of the year, that would give private companies and their auditors almost two years before the issuance of a calendar-year private company's financials to implement the new guidance, but also provide an opportunity for those who wish to be able to apply the guidance earlier. Making the guidance effective in 2015 (for calendar year companies) acknowledges the fact that private companies and their auditors often do not learn about new guidance until later in the year and that the final standard may be issued while their resources are focused on year-end close and other matters.

PCC Question #18: Does the PCC agree that the effective date recommended by the staff in the previous paragraph is appropriate?