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Saving Private Companies

FASB Proposes Alternative Accounting for Private Companies

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On July 1, 2013, the FASB issued for public comment three proposed Accounting Standards Updates (ASUs) that would allow private companies to simplify their reporting under U.S. GAAP by using alternative approaches to account for (1) intangible assets acquired in a business combination, (2) goodwill, and (3) certain types of interest rate swaps. The alternative approaches are intended to reduce the cost and complexity of financial reporting while continuing to provide decision-useful information for users of private-company financial statements.

A Snapshot of the Proposed ASUs	
Topic	The proposals would:
Intangible assets	Narrow the types of intangible assets recognized in a business combination to generally only those that meet the contractual-legal criterion.
Goodwill	Permit amortization of goodwill, require impairment testing only upon triggering events, and simplify performance of the goodwill impairment test.
Interest rate swaps	Offer approaches that result in the recognition of periodic interest expense that is consistent with that for a fixed-rate borrowing.

Background

Since its formation last year, the Private Company Council (PCC) has been tasked with improving the accounting standard-setting process for private companies and, specifically, evaluating whether alternatives to existing and proposed U.S. GAAP are warranted for such companies. In response to outreach efforts, the PCC has proposed and the FASB has subsequently endorsed — within the context of the private-company decision-making framework[1] — the simplified alternative accounting approaches discussed in this *Heads Up*. In addition, at the PCC's upcoming July meeting, the PCC and FASB plan to discuss potential relief to private companies that apply the variable interest entity consolidation model to common-control leasing arrangements.

The alternative accounting approaches in the proposed ASUs are optional and generally available to any private company, which has been described as an entity other than a "publicly traded company" or "not-for-profit entity" (as defined in the *FASB Accounting Standards Codification* (ASC) Master Glossary). In conjunction with issuing the proposed ASUs, the FASB has sought feedback on the definition of the term "public business

[1] On April 15, 2013, the FASB and PCC jointly issued an invitation to comment on an updated version of the private-company decision-making framework. Comments were due by June 21, 2013. For additional details, see Deloitte's April 25, 2013, *Heads Up*.

entity," which is expected to replace the term "publicly traded company." The FASB has tentatively decided that an entity would qualify as a public business entity if it meets any of the following criteria:[2]

- "It is required to file or furnish financial statements with the Securities and Exchange Commission."
- "It is required to file or furnish financial statements with a regulatory agency in preparation for the sale of securities or for purposes of issuing securities."
- "It has issued (or is a conduit bond obligor) for unrestricted securities that can be traded on an exchange or an over-the-counter market."
- "Its securities are unrestricted, and it is required to provide U.S. GAAP financial statements to be made publicly available on a periodic basis pursuant to a legal or regulatory requirement."

Editor's Note: In addition to defining public business entity (and thus which private companies are eligible for the proposed alternative accounting), the FASB staff plans to assess whether any elements of the proposed ASUs should be extended to public companies or not-for-profit organizations. The FASB has asked constituents for feedback on this matter in connection with commenting on the proposed ASUs.

Intangible Assets Acquired in a Business Combination

Under the proposed guidance, entities would potentially recognize fewer intangible assets and more goodwill.

The proposed guidance gives private companies an alternative approach to accounting for the recognition, measurement, and disclosure of intangible assets acquired in a business combination. Under current U.S. GAAP, intangible assets that meet either the contractual-legal criterion or the separability criterion described in the definition of "identifiable" in the ASC Master Glossary must be recognized and measured at fair value on the date of acquisition. The proposed alternative accounting would require entities to recognize only intangible assets that meet the contractual-legal criterion and that arise from noncancellable contractual terms[3] or other legal rights. Intangibles that do not meet these revised criteria (e.g., that only meet the separability criterion) would not be recognized. Entities would therefore potentially recognize fewer intangible assets and more goodwill (because goodwill is a residual asset under the proposed guidance).

Appendix A contains a decision flowchart that outlines the application of the proposed alternative accounting for recognition and measurement of intangible assets. The proposed ASU would not extend or amend the guidance on how entities subsequently measure or test the recognized intangibles (indefinite or finite lived) for impairment.

Editor's Note: Contractual-legal intangibles such as trademarks or trade names, domain names, franchises, order backlogs, patented technology, licensed software, trade secrets, and customer contracts would be recognized under the proposed alternative accounting. Intangible assets such as customer lists, noncontractual relationships, unpatented technology and unregistered trade secrets, processes, or recipes that only meet the separabilty criterion (but not the contractual-legal criterion) under current U.S. GAAP would not be separately recognized at fair value. Instead, they would be recognized as part of goodwill under the proposed accounting framework.

[2] See the summary of board decisions for the FASB's June 6, 2013, meeting.

[3] Under the proposed ASU, a noncancelable contractual term is the portion of a contract that is cancelable only under any of the following circumstances: (1) "at the option of the acquirer, but not at the option of the counterparty"; (2) "at the option of the counterparty but with a penalty in such amount that cancellation is remote at the acquisition date"; (3) "upon the occurrence of some remote contingency"; or (4) "upon the acquirer entering into a new contract with the same counterparty."

ASC 350[4] requires entities to initially recognize intangible assets at fair value. Under the proposal, however, entities would not consider potential renewals or cancellations in determining the fair value of intangibles with noncancelable contractual terms. Nevertheless, they would continue to measure recognized intangible assets that arise from other legal rights that are not contractual in accordance with ASC 820 on a basis that incorporates all market participant expectations.

Private companies would continue to apply the existing disclosure requirements in U.S. GAAP for intangible assets recognized under the proposed alternative accounting. The proposal would also require entities electing to adopt the proposed alternative accounting to disclose the following qualitative information:

- "The nature of identifiable intangible assets acquired in a business combination but not recognized separately from goodwill as a result of applying the accounting alternative."
- "For each major contractual intangible asset recognized and measured under the accounting alternative, a description of the arrangement including its noncancelable term and the basis for determining the value."

Editor's Note: Private companies that elect the alternative accounting for intangible assets would be required to apply all of the proposed ASU's recognition, measurement, and disclosure requirements. In addition, the PCC and FASB have requested feedback on whether the proposed ASU should require private entities that elect to adopt the alternative accounting for intangibles to also adopt the alternative accounting for goodwill.

Private companies would be allowed to amortize goodwill on a straight-line basis over the useful life (not to exceed 10 years) of the primary asset acquired in a business combination.

The proposed ASU indicates that private companies that elect to adopt the alternative accounting would be required to prospectively apply the proposed ASU to all intangible assets arising from new business combinations. Early adoption would be permitted.

Goodwill

Under the proposed guidance, private companies could elect simplified accounting for the following:

- *Amortization of goodwill* — Private companies would be allowed to amortize goodwill on a straight-line basis over the useful life (not to exceed 10 years) of the primary asset[5] acquired in a business combination.
- *Frequency of the test for impairment* — Private companies would be permitted to test goodwill for impairment only when a triggering event occurs instead of having to perform the test annually (or more frequently if indicators of impairment exist), as is required currently.
- *Method of impairment test* — Private companies would no longer need to expend resources identifying and separately testing goodwill for individual reporting units because the unit of account for goodwill would be at the entity-wide level rather than the reporting-unit level. In addition, the proposed ASU would eliminate step 2 of the goodwill impairment test. Instead, entities would measure goodwill impairment as the excess of the entity's carrying amount over its fair value (i.e., using the measurement in step 1 of the goodwill impairment test under current U.S. GAAP in ASC 350-20).

[4] For titles of ASC references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[5] Under the proposed ASU, a primary asset is the "principal identifiable long-lived tangible or intangible asset that is the most significant asset from which the acquired business derives its cash-flow-generating capacity."

Editor's Note: The proposed accounting alternatives significantly reduce the cost and complexities associated with the recognition and ongoing impairment assessment of goodwill. Because goodwill would (1) only be tested for impairment upon the occurrence of a triggering event, (2) amortized over a short useful life, and (3) assessed for impairment at the entity level rather than the reporting-unit level, the number of goodwill impairment calculations performed by private companies would be reduced. In addition, if goodwill is impaired, the impairment amount would be calculated on the basis of existing requirements in step 1 of ASC 350-20, which would eliminate the complexities associated with applying step 2 of the goodwill impairment test in ASC 350-20 (i.e., the hypothetical purchase price allocation to the individual assets and liabilities other than goodwill to determine the goodwill impairment amount).

Private companies would continue to apply the existing disclosure requirements in current U.S. GAAP for goodwill. Since the proposed ASU permits goodwill amortization, private companies that elect the alternative accounting would be required to disclose amortizable goodwill in a manner similar to disclosing other finite-lived intangible assets under ASC 350. Under the proposed ASU, entities would also be required to disclose the weighted-average useful life for amortizable goodwill and the basis used to determine useful life, including a description of the primary asset they used to determine the useful life. Appendix B contains a decision flowchart outlining the application of the alternative accounting for goodwill.

Private companies that elect to use alternative accounting for goodwill would be required to prospectively apply the proposed ASU to all existing goodwill (i.e., commence amortization) and any new goodwill resulting from future business combinations. Early adoption would be permitted.

Private companies would continue to apply the existing disclosure requirements in current U.S. GAAP for goodwill.

Interest Rate Swaps

Private companies that want to issue fixed-rate debt are sometimes unable to do so because it would be cost-prohibitive. Instead, they issue variable-rate debt and then enter into a pay-fixed, receive-variable interest rate swap to achieve the desired economic result. Under current U.S. GAAP, entities must account for the issued debt separately from the interest rate swap and generally must measure the debt at amortized cost and the interest rate swap at fair value. The result is an accounting measurement mismatch that gives rise to volatility in a private company's income statement unless the strict criteria for cash flow hedge accounting are met and such treatment is elected.

To make it easier for private companies that are not financial institutions[6] to achieve the desired accounting treatment without having to comply with the strict cash flow hedge accounting requirements of ASC 815, the proposed ASU outlines two optional alternatives.

The first alternative, described as the "combined instruments approach," would allow private companies to account for the variable-rate debt and the interest rate swap as a single, combined instrument (i.e., a single unit of account) on the face of the balance sheet if all of the following conditions are met:

1. "Both the variable rate on the swap and the borrowing are based on the same index and interest rate" (e.g., the rate on the swap and the debt are both three-month LIBOR).
2. "The terms of the swap are typical . . . and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a comparable floor or cap." (The FASB defines "typical" as "plain vanilla.")
3. "The repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days."
4. "The swap's fair value at inception (that is, at the time of application . . .) is at or near zero."

[6] ASC 942-320-50-1 defines financial institutions as "banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities."

5. "The swap is not a forward-starting swap."
6. "The notional amount of the swap is equal to, or less than, the principal amount of the borrowing."
7. "The term of the swap approximates the term of the borrowing" (e.g., the company's fixed-rate debt and the interest rate swap both have a five-year term).
8. "The swap is effective at the same time as the borrowing or within a few days" (e.g., the company's fixed-rate debt and the interest rate swap both have an effective date of January 1, 201X).

Editor's Note: Under the combined instruments approach, private companies would not recognize the interest rate swap on the balance sheet, except for the periodic interest accrual arising from the next swap settlement. By applying this approach, an entity would, in effect, (1) eliminate the accounting mismatch that would otherwise arise from measuring the swap at fair value and the borrowing at amortized cost and (2) record a fixed amount of interest expense in the income statement each reporting period (which is the desired economic result).

Under the combined instruments approach, private companies would not recognize the interest rate swap on the balance sheet, except for the periodic interest accrual arising from the next swap settlement.

Private companies would present the combined instruments at amortized cost on the balance sheet (i.e., the swap would not be recognized at fair value as is typically required of a derivative). They would disclose (1) the settlement value[7] of the swap, (2) the methods and significant assumptions used to determine the settlement value, and (3) the amount of the borrowing that has been swapped into fixed-rate debt and the amount that remains variable, if any.[8]

A private company that elects to apply the combined instruments approach must apply that approach to all swaps — both existing and future — if all qualifying criteria are met.

The second alternative, called the "simplified hedge accounting approach," would allow private companies to assume no hedge ineffectiveness in a cash flow hedge relationship involving a variable-rate borrowing and a pay-fixed, receive-variable interest rate swap. Under this alternative, a private company would (1) continue to account for the interest rate swap and the variable-rate debt separately on the face of the balance sheet, (2) assume no hedge ineffectiveness in the hedging relationship, and (3) be permitted to measure the interest rate swap at its settlement value rather than its fair value. By applying the simplified hedge accounting approach, an entity would achieve essentially the same income statement effects as if it had issued fixed-rate debt because changes in the settlement value of the swap would be deferred to other comprehensive income and released to the income statement as the hedged interest payments affect the income statement.

To use this approach, a private company would have to meet the same eligibility criteria as it would under the combined instruments approach, with two exceptions. First, the term of the swap would only need to be equal to or less than the term of the borrowing; it would not need to approximate the term of the borrowing as indicated in condition (7) above. Second, the swap would not have to be effective at the same time as the borrowing (i.e., condition (8) above would not apply).

Unlike the combined instruments approach, the simplified hedge accounting approach could be elected by a private company on an instrument-by-instrument basis. To apply the approach, the private company would have to prepare hedge designation documentation similar to the documentation currently required for hedge accounting under ASC 815. However, the company would have "a few weeks" to prepare it (i.e., it would be exempt from the requirement under ASC 815 to have the documentation in place at hedge inception).

[7] The PCC has explained that the "primary difference between a settlement value . . . and fair value is that generally the nonperformance risk of the swap counterparties is not considered in the settlement value."

[8] The proposed ASU would also require disclosure of (1) "the location and amount of the gains and losses in the [income statement] arising from early termination, if any, of the swap" and (2) "the existence and nature of credit-risk-related contingent features" and the related contingent events for swaps in a liability position at the end of the reporting period.

Editor's Note: The simplified hedge accounting approach would allow a private company to assume no hedge ineffectiveness without having to meet the strict criteria for use of the shortcut method in ASC 815-20-25-102 through 25-107. In addition, because the private company would account for its interest rate swap separately from its issued debt under the simplified hedge accounting approach, it would continue to disclose the information required by (1) ASC 815 for derivative instruments and (2) ASC 820 for fair value measurements (although it would disclose the settlement value of the swap if settlement value is used as the measurement basis).

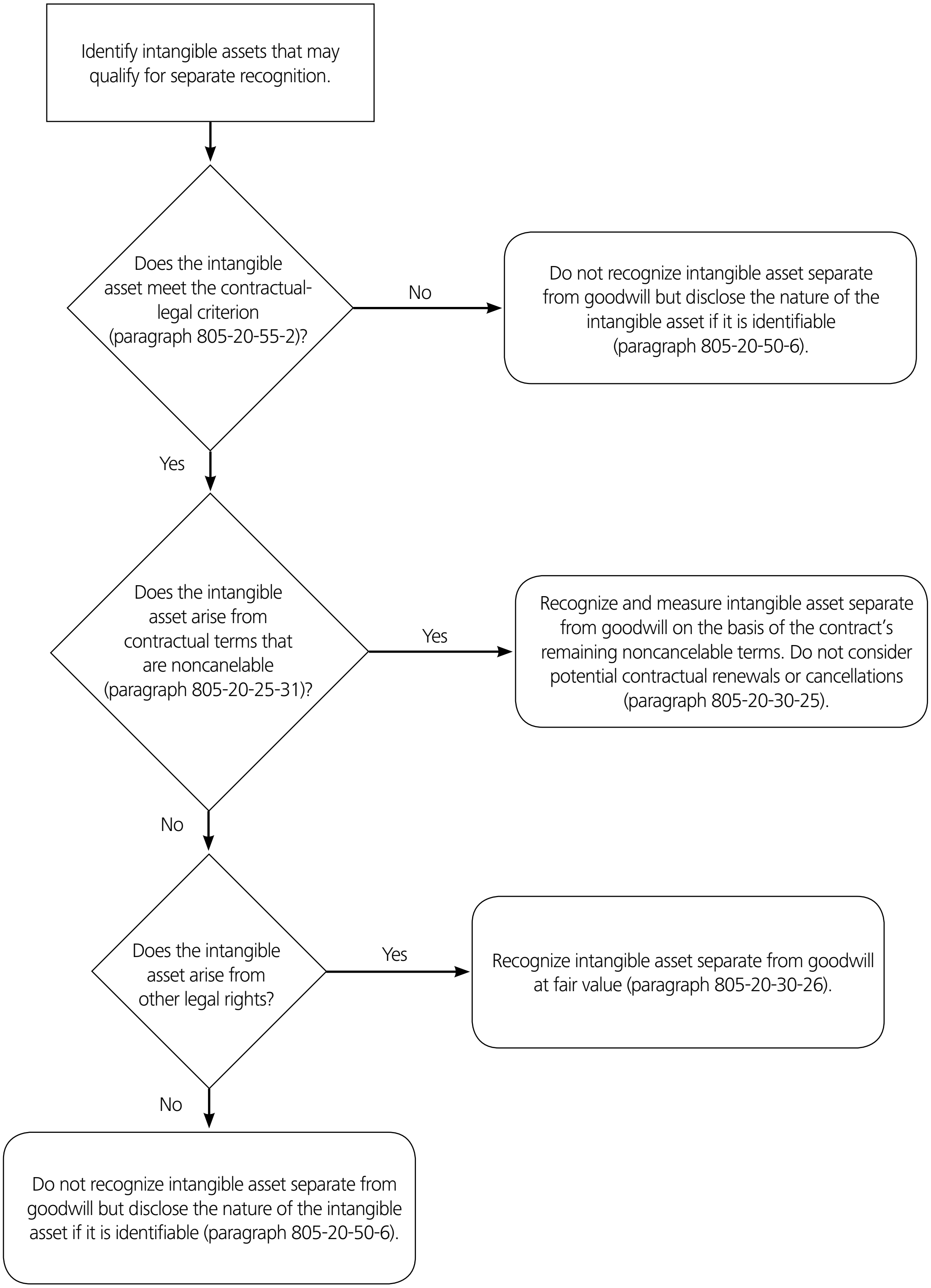
A private company could elect to apply the proposed approaches by using either a full retrospective adoption method or a modified retrospective method (i.e., a cumulative catch-up adjustment recorded in the period of adoption). A private company also could early adopt the guidance. Companies that elect to apply the combined instruments approach would have to apply the approach to all qualifying swaps that exist as of the date of adoption and to all future qualifying swaps. Alternatively, companies that elect to apply the simplified hedge accounting approach could apply it to any qualifying swap existing as of that date and to any future qualifying swap. Companies also would need to provide certain disclosures on their adoption of an approach.

Next Steps

Comments on the three proposed ASUs are due by August 23, 2013, and will be discussed at the PCC's September 30, 2013, meeting. The FASB and PCC will determine effective dates for the final standards after considering feedback on the proposals. Changes to the proposals will be subject to a final vote by the PCC before the proposals are sent to the FASB for a decision on endorsement.

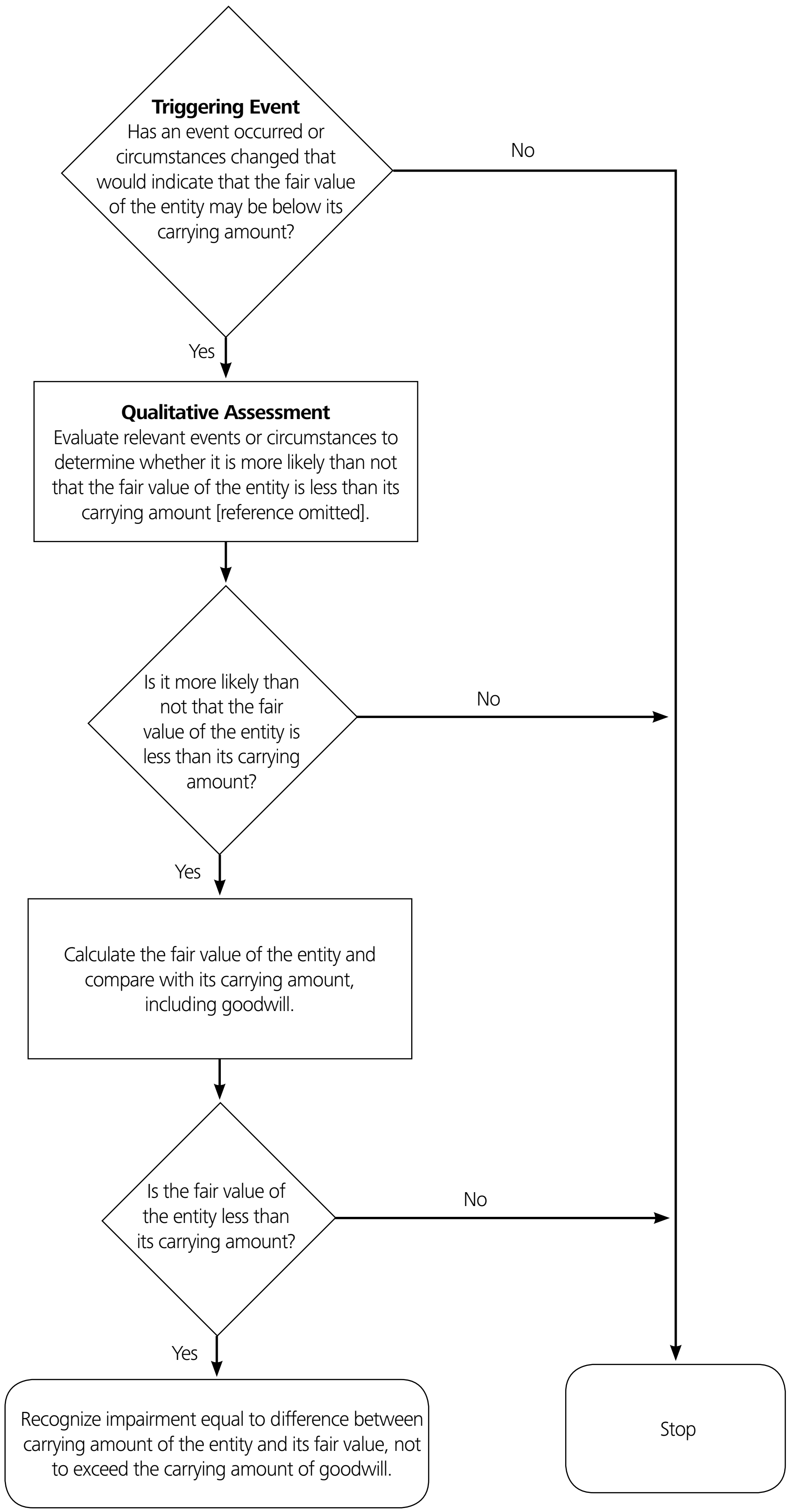
Appendix A — Alternative Accounting for Intangible Assets Acquired in a Business Combination

The decision flowchart below was reproduced from the FASB's proposed guidance. It outlines application of the proposed alternative accounting for intangible assets.



Appendix B — Alternative Accounting for Goodwill

The decision flowchart below was reproduced from the FASB's proposed guidance. It outlines application of the proposed alternative accounting for goodwill.



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