FINANCIAL ACCOUNTING STANDARDS BOARD

Memo

Memo No.	**Issue Summary No. 2**
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Meeting Date(s)	**July 21, 2015 PCC Meeting**

Contact(s)	**Mark Barton**	Lead Author	Ext. 467
	Michael Cheng	Co-Author/PCC Coordinator	Ext. 236
	Jeffrey Mechanick	Assistant Director	Ext. 301
	Larry Weinstock	PCC Liaison	

Project	**PCC Issue No. 15-01, "Effective Date and Transition Guidance"**
Project Stage	**Pre-Agenda Research**
Issue(s)	**Agenda Planning for and Potential Decisions on Assessing Preferability when Electing a Private Company Accounting Alternatives and Extending Transition Guidance beyond the Effective Date for Adopting Private Company Accounting Alternatives**

Objective(s) of this Memo

1. The purpose of this memo is to provide an update on staff research performed on two issues and to assist the Private Company Council (PCC) in determining whether to add those issues to its technical agenda. The first issue is whether private companies should be required to assess preferability when electing a private company accounting alternative. The second issue, which can be considered separately, is whether transition guidance should be extended beyond the effective date for adopting private company accounting alternatives promulgated by the PCC (PCC alternative).

Issue 1: Assessing Preferability When Electing a Private Company Accounting Alternative

Background

2. Some PCC members previously expressed concern about the assessment of preferability when a PCC alternative is elected for the first time after its effective date. Specifically,

those PCC members were concerned about scenarios in which (a) it may be suboptimal for an entity to elect a PCC alternative by its effective date due to that entity's specific facts and circumstances and (b) there may be a lack of awareness of accounting alternatives that a private company may be eligible to consider. Under existing guidance, if a private company does not elect a PCC alternative before its effective date, it must assess the preferability of the alternative in accordance with Topic 250, Accounting Changes and Error Corrections. PCC members were concerned that if a private company does not make the election to apply the PCC alternative by the effective date, the company subsequently would be subject to a preferability assessment that may prevent it from making that election.

3. At its May 5, 2015 meeting, the PCC discussed the possibility of an unconditional one-time option to make a first-time election of a PCC alternative that would permit private companies to forgo an initial preferability assessment. The option would still require a private company to assess preferability after its initial election of a PCC alternative. The PCC also discussed several potential alternatives to an unconditional one-time option. For example, some FASB members proposed that the PCC should instead extend the one-time option to all private company accounting alternatives or amend Topic 250 to indicate that all private company accounting alternatives are preferable. Other alternatives discussed included potentially eliminating the requirement for private companies to assess preferability.

4. The PCC did not add this issue to its agenda at the May 5, 2015 PCC meeting. Rather, the PCC directed the staff to perform additional research on the various effective date alternatives discussed by the PCC and FASB members.

Summary of Current Requirements

5. Topic 250 requires an accounting principle adopted for the preparation of financial statements to be applied consistently when accounting for similar events and transactions. However, an entity may change an accounting principle (that is, adopt a "voluntary change") if it justifies the use of an allowable alternative accounting principle on the basis that it is preferable. Paragraph 250-10-55-1 states:

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

6. Most of the guidance on assessing preferability is derived from APB Opinion No. 20, *Accounting Changes* (APB 20), which was substantially reaffirmed in FASB Statement No. 154, *Accounting Changes and Error* (Statement 154), and ultimately codified in Topic 250. To support the concept of preferability, APB 20 states that an accounting principle once adopted should not be changed for events and transactions of a similar type. However, the dissent in APB 20 provides further insight into the rationale behind requiring an assessment of preferability:

> This Opinion recognizes that… changes in accounting principles should not be made unless the principle adopted is "preferable"…. Messrs. Catlett, Harrington and Luper are particularly concerned with the continuing tendency of the Board to attempt to eliminate alleged "abuses" by means of arbitrary rules and to use accounting requirements as a disciplinary tool rather than to establish standards for the most meaningful financial reports for investors and other users of financial statements. They believe that the cumbersome requirements of this Opinion will discourage improvements in accounting in numerous areas on which the Board will not issue Opinions for many years.

SEC Guidance

7. While not required for private companies, some private constituents may refer to U.S. Securities and Exchange Commission (SEC) Staff Accounting Bulletin Topic 6.G.2.b, *Reporting Requirements for Accounting Changes* (SAB 6.G.2.b), for additional guidance on assessing preferability. SAB Topic 6.G.2.b reinforces the requirements of Topic 250 and states that each registrant must justify a change in accounting method on the basis that the new method is preferable under the registrant's particular circumstances. SAB Topic 6.G.2.b also states that a registrant's particular circumstances, such as general economic trends on its business (for example, the impact of inflation), its expectation regarding expanding consumer demand for its products, and its plans for a change in marketing methods, are appropriate examples of business judgement that should be evaluated in determining preferability.

Audit Requirements

8. Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, and Auditing Standards Board AU-C Section 708, *Consistency of Financial Statements,* require an auditor to evaluate whether the comparability of the financial statements between periods has been materially affected by a change in accounting principle. Auditors are also required to include an emphasis-of-matter paragraph in their audit report if a change in accounting principle has a material effect on the financial statements. However, those auditing standards do not provide additional guidance on how to assess preferability.

Lack of Guidance

9. Overall, very little authoritative guidance exists for evaluating the reasonableness of management's justification for a voluntary change in accounting principle. As a result, diversity in practice exists in assessing preferability, especially among private companies. For some private company preparers and practitioners, assessing preferability of a PCC alternative will not be a difficult or complex assessment. However, there is a concern that some private companies will experience pushback from practitioners who disagree with the companies' preferability assessments, resulting in added cost and complexity. Some may argue that PCC alternatives are clearly preferable because those alternatives are a consensus of the PCC and endorsed by the Board. Others may argue that PCC alternatives are alternatives to the preferred public business entity accounting and thus would never be preferable under Topic 250.

10. Currently, Accounting Standards Updates (ASU) No. 2014-02, *Intangibles—Goodwill and Other (Topic 350)*; ASU No. 2014-03, *Derivatives and Hedging (Topic 815)*; and ASU No. 2014-07, *Consolidation (Topic 810)*, are effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. As a result, a private company that has a calendar year-end and an in-scope transaction (for example, goodwill, an interest rate swap, or a leasing arrangement with a VIE under common control) will have to make an election to adopt the PCC alternatives by the time its 2015 annual financial statements are made available for issuance. If that private company does not elect the PCC alternatives by the time its

2015 annual financial statements are made available for issuance, it will be subject to a preferability assessment in any subsequent year that it chooses to elect the accounting alternatives. ASU No. 2014-18, *Business Combinations (Topic 805),* shares a similar effective date and adoption concerns to the aforementioned ASUs; however, its effective date is one year later.

Questions for the Private Company Council
Question 1. Does the PCC wish to add this issue to its agenda? (Question 2 is only applicable if the PCC answers "yes" to Question 1) **Question 2**. Which Alternative does the PCC support (that is, Alternative A, B, C, or D)?

Summary of Staff Research

11. Subsequent to the May 5, 2015 PCC meeting, the staff performed outreach with both large and small practitioners. Based on the feedback received from both PCC and Board members at the May 5 meeting, the staff solicited feedback on the following alternatives:

    (a) *Alternative A*—Grant private companies an unconditional one-time option to make an election of a ***PCC alternative*** that would permit private companies to forgo an initial preferability assessment.

    (b) *Alternative B*—Grant private companies an unconditional one-time option to make an election of ***any private company accounting alternative*** that would permit private companies to forgo an initial preferability assessment.

    (c) *Alternative C*—Provide additional authoritative guidance by amending Topic 250 to state that a change in business circumstances could indicate that election of a private company accounting alternative subsequent to its effective date constitutes an improvement in financial reporting. In addition, Topic 250 would be amended to include an example of a change in business circumstances that would render adoption of a private company accounting alternative as preferable.

    (d) *Alternative D*—Eliminate the requirement for private companies to assess preferability in all cases.

12. Some practitioners agreed that the preferability assessment required by Topic 250 is neither insurmountable nor punitive as long as a private company has a reasonable basis for voluntarily electing the accounting alternative. For example, if the owners of a private company had anticipated an initial public offering (and, therefore, did not elect any private company accounting alternatives as of those accounting alternatives' respective effective dates), but later decided that doing so was not feasible or desirable, the private company should be permitted to adopt existing private company accounting alternatives.

13. A majority of practitioners that participated in the staff outreach said the best way to address the concerns raised by private companies is to provide additional guidance on how preferability of a private company accounting alternative should be assessed. Those practitioners said that providing additional guidance will help with the assessment of the preferability of existing and future private company accounting alternatives. One practitioner suggested that also permitting a one-time option to make a first-time election of a PCC alternative would help to further reduce diversity in how preferability of those accounting alternatives is assessed and would provide relief to entities that did not become aware of the accounting alternative until after its effective date. No practitioners supported eliminating the requirement for private companies to assess preferability in all cases.

Staff Analysis

Alternatives A and B

14. Proponents of *Alternative A* (an unconditional one-time option to make a first-time election of a ***PCC alternative***) and *Alternative B* (an unconditional one-time option to make a first-time election of ***any private company accounting alternative***) believe that it is counterproductive to conclude that a private company accounting alternative is not preferable when changes in management's strategic plan or circumstances could make private company accounting alternatives more appropriate. Proponents of *Alternative A* and *Alternative B* believe that an unconditional option would appropriately permit a private company to adopt a private company accounting alternative after its effective date

when the private company experiences a change in management's strategic plan or circumstances.

15. Opponents of *Alternative A* and *Alternative B* believe that private companies are already granted a deferred effective date and providing an unconditional one-time option goes beyond the intended goal of providing private companies with some accounting relief. Opponents also believe that an unconditional one-time option perpetuates the behavior of private company preparers and practitioners who are not staying current with GAAP. Private company preparers may incorrectly assume that future PCC considerations will feature similar provisions or be similarly amended. Opponents also point out that *Alternative A* and *Alternative B* fail to address the diversity in how preferability would be assessed subsequent to a private company exercising its one-time unconditional option.

16. Furthermore, opponents believe that *Alternative B* would be difficult to implement. The Codification includes certain private company accounting alternatives that the Board has concluded are not preferable. For example, Topic 718, *Compensation—Stock Compensation*, permits a "nonpublic entity" to account for liability-classified awards using either the fair-value method or the intrinsic-value method. The basis for conclusions in FASB Statement No.123 (revised 2004), *Share-Based Payment* (Statement 123(R) is codified in Topic 718), states that the fair-value based method of accounting is preferable. Accordingly, a change from the fair-value method to the intrinsic-value method would not be deemed preferable.

17. Opponents do not believe that the purpose of an unconditional one-time option is to permit private companies to adopt an accounting policy that the Board previously determined was not preferable. Accordingly, a standard-by-standard analysis would be required to determine which "nonpublic entity" or "private company" accounting alternatives should be subject to the unconditional one-time option.

18. The staff does not believe that granting an unconditional one-time option on a standard-by-standard analysis would change how practice assesses preferability. However, if the PCC and the Board agree to expose an unconditional one-time option, the staff believes that it is important to point out that an unconditional one-time option does not presume that private company accounting alternatives are preferable for private companies. Under

that approach, subsequent changes in accounting policy would still be subject to a preferability assessment, which would continue to prevent a private company from switching back and forth between accounting alternatives to achieve a desired financial reporting result.

Alternative C

19. Proponents of *Alternative C* (provide additional authoritative guidance in Topic 250, including an example of a change in business circumstances that would render adoption of a private company accounting alternative as preferable) believe that providing an example within Topic 250 to demonstrate when a private company accounting alternative might be preferable would address private company concerns about scenarios in which it may be suboptimal for an entity to elect a private company accounting alternative by its effective date due to that entity's facts and circumstances. Proponents of *Alternative C* believe that an example that could be included in Topic 250 is one in which a private company's owners plan to take their company public, but later decide to keep it private. Prior to the owner's planned strategic change, that private company likely would not have adopted the private company accounting alternatives, but after the owner's decision not to make a strategic change, that private company would likely benefit from adopting the accounting alternatives.

20. Furthermore, proponents of *Alternative C* believe that including an example in Topic 250 would not affect the quality of information provided to users of private company financial statements because it would permit a private company to elect a private company accounting alternative after its effective date only when a private company's facts and circumstances justify the change. Rather, proponents of *Alternative C* believe that including an example in Topic 250 would help address some of the diversity that exists in assessing preferability today.

21. Opponents of *Alternative C* believe that inclusion of an example in Topic 250 would not sufficiently address the challenges that private companies face. For example, inclusion of an example in Topic 250 would not address circumstances in which a private company was unaware of a PCC alternative and, therefore, did not adopt the accounting alternative at its effective date.

Alternative D

22. Proponents of *Alternative D* (eliminate the requirement for private companies to assess preferability) believe that private company accounting alternatives exist in GAAP in order to reduce the burden of financial reporting for private companies. Accordingly, proponents of *Alternative D* do not believe that a private company should have to assess preferability when adopting a private company accounting alternative.

23. Opponents of *Alternative D* do not believe that eliminating the requirement for private companies to assess preferability is in the best interest of private company financial statement users. Opponents believe that doing so could compromise the quality of financial information provided to users of private company financial statements by introducing volatility and the potential for earnings management.

24. Furthermore, opponents believe that eliminating a GAAP requirement for private companies to assess preferability would create an inconsistency with the GAAS requirements in AICPA Auditing Standards Board AU-C Section 708, *Consistency of Financial Statements*, that require an auditor to evaluate whether the comparability of the financial statements between periods has been materially affected by a change in accounting principle.

Staff Recommendation

25. The staff recommends that this issue be added to the PCC agenda. The staff believes that doing so could help reduce the diversity in how practitioners assess preferability for private company accounting alternatives.

26. The staff recommends *Alternative C*. The staff believes that *Alternative C* adequately addresses the concerns of private company stakeholders while not compromising the quality of financial information provided to users of private company financial statements. The staff also believes that *Alternative C* is operational, helps reduce diversity in how preferability is assessed, could be easily implemented, and is consistent with existing GAAS requirements. The staff does not believe that *Alternative B* or *Alternative D* are viable options.

Issue 2: Extending Transition Guidance beyond the Effective Date for Adopting Private Company Accounting Alternatives

Background

27. Transition guidance under existing PCC alternatives is only available if a private company elects to adopt the accounting alternative during the effective date window associated with the ASU. Currently, an interpretation of paragraph 250-10-45-5 would require a private company that voluntarily elects a PCC alternative subsequent to the effective date (considered to be a change in accounting principle) to apply the accounting alternative retrospectively. In general, retrospective application of a PCC alternative could be costly and diminish the relief provided by the accounting alternative as compared to the transition guidance provided in two of the PCC-derived ASUs.

28. The transition guidance in ASU No. 2014-02 states that a private company shall apply the accounting alternative prospectively if adopted within the effective date window. Prospective application permits private companies to amortize existing goodwill over a period of 10 years or less. Absent that transition guidance, private companies would be required to apply the accounting change on a full retrospective basis. Full retrospective application would require a private company to recast all financial statement periods presented as if the accounting election had been made at the time of its first business combination. Full retrospective application of ASU No. 2014-02 would require a private company to undo all previously recorded goodwill impairments and subsequently apply the amortization alternative, along with any impairment charges under the simplified impairment test, to each business combination.

29. The transition guidance in ASU No. 2014-03 permits private companies to apply the simplified hedge accounting approach to existing interest rate swaps[1] that meet the criteria

[1] **815-10-65-6(c)** The simplified hedge accounting approach may be elected for any qualifying receive-variable, pay-fixed interest rate swap, whether existing at the date of adoption of the pending content that links to this paragraph or entered into after that date. The election to apply the simplified hedge accounting approach to an existing swap shall be made upon adoption of the pending content that links to this paragraph. In determining whether an existing swap meets all of the conditions in paragraph 815-20-25-131D to qualify for applying the simplified hedge accounting approach, the condition that the swap's fair value at the time of application of this approach is at or near zero need not 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 entity may apply the simplified hedge accounting approach. For an

in paragraph 815-20-25-131D,[2] excluding the condition that the swap's fair value at the application of the simplified hedge accounting approach be at or near zero. After the effective date, private companies will no longer be permitted to apply the simplified hedge accounting approach to existing swaps (transition exception) upon initial election of the simplified hedge accounting approach.

30. The transition guidance in ASU No. 2014-07, requires full retrospective application. ASU No. 2014-18, is only applied to prospective transactions as discussed in recognition section of Subtopic 805-20 in paragraph 805-20-15-3. Thus, private companies are subject to the same requirements whether or not they elect to adopt these ASUs by their effective dates.

31. At its May 5, 2015 meeting, the PCC briefly discussed whether transition guidance for PCC alternatives should be extended beyond the effective date. The PCC did not add this issue to its agenda at its May 5, 2015 meeting. Instead, the PCC directed the staff to perform additional research concurrent with the staff's research on effective date alternatives.

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existing swap, the documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed in the period of adoption by the date on which the first annual financial statements are available to be issued rather than concurrently at hedge inception.

[2] **815-20-25-131D** An eligible entity under paragraph 815-20-25-131B must meet all of the following conditions to apply the simplified hedge accounting approach to a cash flow hedge of a variable-rate borrowing with a receive variable, pay-fixed interest rate swap:

a. Both the variable rate on the swap and the borrowing are based on the same index and reset period (for example, both the swap and borrowing are based on one-month London Interbank Offered Rate [LIBOR] or both the swap and borrowing are based on three-month LIBOR). In complying with this condition, an entity is not limited to benchmark interest rates described in paragraph 815-20-25-6A.
b. The terms of the swap are typical (in other words, the swap is what is generally considered to be a "plain-vanilla" swap), 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 the derivative was executed to hedge the interest rate risk of the borrowing) is at or near zero.
e. The notional amount of the swap matches the principal amount of the borrowing being hedged. In complying with this condition, the amount of the borrowing being hedged may be less than the total principal amount of the borrowing.
f. All interest payments occurring on the borrowing during the term of the swap (or the effective term of the swap underlying the forward starting swap) are designated as hedged whether in total or in proportion to the principal amount of the borrowing being hedged.

Questions for the Private Company Council
Question 3. Does the PCC wish to add this issue to its agenda? (Questions 4 and 5 are only applicable if the PCC answers “yes” to Question 3) **Question 4**. Does the PCC wish to extend transition guidance beyond the effective date (“indefinite transition guidance”) for ASU 2014-02 (Goodwill)? **Question 5**. Does the PCC wish to extend transition guidance beyond the effective date for ASU 2014-03 (Swaps) for private companies that elect the simplified hedge accounting approach for the first time? A “yes” answer to questions 4 and/or 5 would relocate existing transition guidance for ASU 2014-02 and/or ASU 2014-03 to the recognition section of the codification for those ASUs.

Summary of Staff Research

32. Subsequent to the May 5, 2015 PCC meeting, the staff performed outreach with both large and small practitioners. The practitioners generally did not agree with the concept of indefinite transition guidance because it is their understanding that when the ASUs that resulted from PCC decisions to provide private company accounting alternatives were drafted, ample consideration was given to creating reasonable effective dates and transition guidance. Some practitioners said that providing indefinite transition guidance for PCC alternatives is arbitrary and would not be in the best interest of users of private company financial statements. Other practitioners said that indefinite transition would appropriately addresses the concerns and challenges of private companies.

33. In addition, some practitioners said that full retrospective application under Topic 250 is not punitive in most cases and provides users of financial statements with meaningful information that allows for comparability of financial information across all reporting periods presented.

Staff Recommendation

34. The staff recommends no changes to ASU 2014-07 (VIEs) and ASU 2014-18 (Intangibles) because private companies are subject to the same transition requirements whether or not they elect to adopt these ASUs by their effective date.

35. The staff recommends that the PCC extend transition guidance beyond the effective date for ASU 2014-02 (Goodwill) and ASU 2014-03 (Swaps). The staff believes that one of the overarching goals of these two ASUs was to provide an accounting alternative within GAAP that reduces cost and complexity without diminishing the quality of information provided to users of financial statements. Accordingly, the staff believes that the same transition relief should be granted if a PCC alternative is adopted after the effective date. Most importantly, the staff believes that the recommendation is consistent with the intent of the Private-Company Decision Making Framework.

36. If the PCC decides to make the transition guidance for ASU 2014-03 (Swaps) indefinite, the staff strongly recommends that the transition exception (that is, applying the accounting alternative to existing swaps) only be permitted the first time a private company applies the simplified hedge accounting approach. Any subsequent elections of the simplified hedge accounting approach should be restricted from applying the transition exception because it could undermine hedge accounting. In FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activitie*s, the Board concluded that upfront designation of a hedge is critical; without it an entity could retroactively identify a hedge to achieve a desired accounting result (Statement 133, paragraph 385 of Appendix C). Hedge accounting is elective on a swap-by-swap basis and it is questionable whether the preferability assessment would prevent management from applying the transition exception under ASU 2014-03 (Swaps) to cherry-pick swaps to manage earnings. The staff does not maintain a similar concern for ASU 2014-02 (Goodwill) because the accounting alternative applies to all goodwill. Furthermore, the staff believes that the preferability assessment would be effective in preventing management from freely switching accounting methods to account for goodwill. As such, the staff does not believe that prospective application of goodwill amortization presents a similar opportunity to achieve a desired accounting result.