

**Private Company Council  
Agenda Report  
February 12, 2013 Agenda Decisions**

**Decisions on Proposed New Issues**

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**Private Company Council**  
**Description of Potential New Issue**  
**Discussion Date: February 12, 2013**

**Issue 1: Accounting for Identifiable Intangible Assets in a Business Combination**

**Background**

*Summary of current accounting guidance – initial recognition and measurement*

1. An acquirer must recognize all assets acquired and liabilities assumed in a business combination at their acquisition-date fair values in accordance with Topic 805, Business Combinations, including intangible assets that are identifiable. As defined in the Master Glossary, intangible assets are identifiable when they meet either one of the following criteria:

- a. It is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so.
- b. It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

2. Therefore, an acquirer must determine the fair value of identifiable intangible assets even if those intangibles were not previously reported in the acquired entity's pre-acquisition financial statements (for example, customer relationships). Topic 805 requires that identifiable intangibles, both finite and indefinite-lived, must be recognized separately from goodwill.

3. Goodwill is a residual value in a business combination; its value is only determinable after fair values are assigned to the assets acquired and liabilities assumed in the acquisition. Paragraph 805-30-30-1 describes the measurement of goodwill as follows:

The acquirer shall recognize goodwill as of the acquisition date, measured as the excess of (a) over (b):

- a. The aggregate of the following:
  1. The consideration transferred measured in accordance with this Section, which generally requires acquisition-date fair value

2. The fair value of any noncontrolling interest in the acquiree
  3. In a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree
- b. The net of the acquisition-date amounts (fair values) of the identifiable assets acquired and the liabilities assumed measured in accordance with this Topic.

*Summary of current accounting guidance - subsequent measurement*

4. Topic 350, Intangibles—Goodwill and Other, requires an intangible asset (that is not indefinite-lived) to be amortized over its estimated life. There is no recurring impairment testing; impairment is triggered upon the occurrence of events or changes in circumstances that indicate the carrying value of the intangible asset may not be recoverable (Topic 360).

5. In contrast to other intangibles, an indefinite-lived intangible (ILI) is not amortized, but is subject to impairment testing at least annually pursuant to Topic 350. An ILI is considered impaired if its carrying value exceeds its fair value. However, under FASB Accounting Standards Update No. 2012-02, *Intangibles—Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment*, issued July 2012, the ILI impairment test has been simplified by permitting an entity to first perform a qualitative assessment to determine whether it is necessary to perform the quantitative impairment test. The impairment amount is the excess of the carrying value of an ILI over its fair value.

6. Similar to ILI, goodwill is not amortized and is subject to impairment testing at least annually. The unit of account for goodwill is at the level of the entity referred to as a reporting unit. Goodwill is assigned to specific reporting units for purposes of the impairment assessment. In 2011, the Board simplified the goodwill impairment test by permitting an entity to first perform a qualitative assessment to determine whether it is necessary to perform the quantitative impairment test. When an entity determines qualitatively that further testing is necessary, the first step of the goodwill impairment test is performed to calculate and compare the fair value of a reporting unit to its carrying amount. If the carrying amount exceeds the fair value, the entity then performs the second step to measure the impairment amount, if any, by calculating the "implied fair value" for goodwill. Implied fair value is calculated in the same way goodwill is calculated in a business combination, which requires that the entity determine the fair value of all of its assets (including intangible assets) and liabilities of a reporting unit at the impairment test

date. If the carrying amount of a reporting unit's goodwill exceeds its implied fair value, an impairment loss is recognized in an amount equal to the excess.

*Summary of preliminary feedback*

7. Private companies may incur significant costs related to their efforts to separately identify intangible assets acquired in a business combination, including external valuation and audit costs. The significant judgments, complex models, market information, expertise, and processes necessary to separately value intangible assets often require that private companies seek help from external professionals. While the significance of costs vary from entity to entity, many private companies and their users question the benefit derived from such a costly exercise. Users commonly note that separate identification of intangible assets does not help them with their decision-making because they are primarily focused on balances that affect reported cash balances, cash flows, tangible net worth, or adjusted EBITDA, which intangible assets and related amortization charges do not affect. The FASB staff will perform additional outreach in preparation for PCC's deliberation of this project.

**Scope**

8. This issue applies to private companies that are required to apply the provisions of Topic 805 as a result of a business combination, as described above.

**Accounting Issue and Alternatives**

**Issue: How a private company should recognize identifiable intangible assets acquired in a business combination (separate from goodwill).**

9. The FASB staff has identified two broad alternatives to current guidance on recognizing intangibles in a business combination but believes that a more comprehensive study of alternatives and implications should be considered by the PCC at a future meeting. Appendix A provides additional analysis of this issue in relation to the Private Company Decision Making Framework, as well as other considerations.

10. In addition to addressing the initial recognition of intangible assets, as a follow on issue, the FASB staff believes that the PCC may also need to address subsequent measurement of goodwill for the following reasons:

- a. Any exceptions or expedients to the initial recognition of intangibles for private companies could increase the goodwill amount recognized on the acquisition date. Accordingly, at a minimum, the PCC would have to revisit how goodwill impairment is calculated under step two of the goodwill impairment test such that the calculation of implied goodwill is conformed to how goodwill is initially determined.
- b. Goodwill, or at least a portion of goodwill, may have to be subject to amortization if the PCC decides to allocate to goodwill finite-lived intangibles that would otherwise be separately recognized and amortized under current guidance.

*View A: A private company should separately recognize **some but not all** identifiable intangible assets in a business combination (for example, executory contract intangibles or intangibles with evidence of being separately exchanged).*

11. Under View A, some but not all identifiable intangible assets would be recognized separately from goodwill by a private company. Effectively, this alternative would constitute a modification to U.S. GAAP by introducing a new and narrower definition of an "identifiable intangible asset" for private companies. For example, the PCC may decide that only intangibles arising from executory contracts (but not simply from purchase orders as in the case of customer relationships) should be recognized by private companies. Another approach could be to introduce a practicability exception, for example, by indicating that an intangible asset need not be recognized if it has no evidence of observable exchange transactions, or otherwise the fair value cannot be measured on a sufficiently reliable basis. A similar concept has currently been adopted by IFRS for SMEs, and was discussed as a potential alternative during the Board's deliberations of FASB Statement No. 142, *Intangibles and Goodwill*.

12. Proponents of View A indicate that recognizing all identifiable intangibles is not necessary, because most users of private company financial statements disregard intangible asset balances since they are primarily focused on tangible net worth and EBITDA-type measures. In

particular, lenders generally exclude intangible asset balances from their calculation of tangible net worth and debt covenant compliance calculations. Investors find fair value information relevant in certain cases (for example, when they are contemplating buying or selling a business), but only for the enterprise value and/or the stock value, and not for the fair values of the individual assets. Accordingly, proponents of View A believe that the costs of separately identifying all intangible assets acquired in a business combination do not justify the benefits.

13. Proponents of View A do however agree that certain intangibles, such as those resulting from an executory contract and/or those with observable exchange transactions, should be separately recognized to properly reflect their values on the balance sheet separate from goodwill. Because such intangibles, by their nature, are more prone to being frequently bought, sold, or otherwise settled on a separate basis, this accounting would also ensure a more fair representation of their subsequent gain/loss recognition upon sale or transfer. From a cost perspective, proponents of View A believe that these types of intangibles are generally less difficult and therefore less costly to value than other intangibles because there is greater certainty in their cash flows (in the case of executory contracts), and better evidence of their fair value (in the case of intangibles with history of separate exchange).

14. Opponents of View A believe that separately recognizing all identifiable intangibles from goodwill is more representationally faithful than allocating all or some intangibles into goodwill. When the current guidance was first introduced, the Board specifically cited FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, which states that "analysis aimed at objectives such as predicting amounts, timing, and uncertainty of future cash flows requires financial information segregated into reasonably homogenous groups." Based on that principle, the Board concluded that intangibles that are identifiable should be recognized separately from goodwill. At the time, the Board defined "identifiable" broadly because it believed that history of individual exchange transactions was not the only evidence of separability (that is, intangible assets are often coupled with other assets when they are sold). The opponents acknowledge that the fair value estimates for some intangible assets might lack the precision of the fair value measurements for other assets. However, they also believe that the financial information that will be provided by recognizing all

intangible assets at their fair values is more representationally faithful than that which would be provided if those intangible assets were subsumed into goodwill on the basis of measurement difficulties.

*View B: A private company should not recognize **any** intangible assets separately from goodwill in a business combination.*

15. Under View B, a private company's intangible assets acquired in a business combination would not be recognized separately from goodwill. The value of any excess purchase price over net assets (excluding intangibles) would be fully allocated to goodwill. A private company would continue to be required to determine the fair value of all other tangible assets acquired and liabilities assumed in a business combination pursuant to Topic 805, but it would not be required to follow the criteria to identify and recognize intangibles separately from goodwill.

16. Proponents of View B agree with proponents of View A, but go further by arguing that no intangible assets should be recognized separately from goodwill because the benefits do not justify the costs associated with valuing such intangible assets. Most intangibles—whether they are contractual or not—do not have observable prices in an active market; therefore, developing market participant assumptions for intangible assets requires significant judgment. The valuation inputs used typically include cash flow forecasts as well as discount rates, contributory asset charges, tax amortization benefits, and other inputs. Because of the difficulty involved in developing those inputs and assumptions, private companies often hire external valuation specialists to determine the fair value. Auditors then have to audit those valuations, which also may require the involvement of a specialist from the auditor's firm. All of those external efforts lead to significant costs for many private companies.

17. Proponents of View B also acknowledge that the new and narrower definition of "identifiable" in View A may be less costly to apply than current guidance. However, they believe that View A may introduce unnecessary complexity, especially for auditors when evaluating which intangibles have an observable history or evidence of being separately exchanged, and which intangibles can be reliably measured. Notwithstanding that complexity,

proponents believe that even the potentially lower costs of View A are not justifiable because reporting intangibles separately from goodwill does not provide decision-useful information.

18. Opponents of View B (similar to opponents of View A) believe that recognizing all identifiable intangibles separately from goodwill is more representationally faithful than allocating intangibles to goodwill. They argue that allocating all intangibles to goodwill would diminish, not improve, the usefulness of financial statements. Moreover, they believe that an intangible asset that arises from contractual or other legal rights is an important characteristic that distinguishes many intangible assets from goodwill and, therefore, acquired intangible assets with that characteristic, at a minimum, should be recognized as an asset apart from goodwill. Opponents also believe that including finite-lived intangible assets in goodwill that is not being amortized would further diminish the usefulness of subsequent financial statements.

#### **Potential follow on issue**

19. As noted earlier, the FASB staff believes that the PCC may also need to consider the ramifications for the subsequent accounting for goodwill. This may be especially relevant if the PCC were to decide that no finite-lived intangible asset should be recognized separately from goodwill (View B), which is not amortized.

20. For example, the PCC may consider an alternative in which a private company would amortize goodwill and test goodwill for impairment only when there are indicators (triggers) that the carrying value of a reporting unit is not recoverable (a considerably higher threshold than today's model).

21. Proponents of amortizing goodwill believe that users would not be adversely affected by going to an amortization model because they often ignore goodwill and related impairment charges from their quantitative analysis. While goodwill amortization expense would reduce an entity's earnings, proponents argue that many users of private company financial statements evaluate earnings performance based on some variation of EBITDA. Most debt covenant calculations would not be impacted because substantially all covenant calculations are based on

EBITDA. This change would also align with IFRS for SME's, which requires an entity that does not have public accountability to amortize goodwill.

22. Opponents of amortizing goodwill believe that systematic amortization does not align with the economics of the goodwill recognized because not all goodwill declines in value and because it is difficult to estimate a useful life and an appropriate amortization method for goodwill. The possibility of amortizing goodwill was considered, but not fully explored by the Board in connection with its recent project to simplify the goodwill impairment test.

23. The Board's deliberations at the time did not contemplate a change that certain intangibles may be subsumed into goodwill. Because such intangibles are currently subject to amortization, such a change would result in a higher goodwill amount, which would not be subject to amortization under current guidance. This would result in higher earnings for companies than today. Therefore, if the PCC decides to give private companies an exception for recognizing certain intangibles, the FASB staff believes that the PCC may also need to decide whether amortization would be a more appropriate model for goodwill since it would represent a broader pool of intangibles than under today's guidance. Otherwise, private company earnings may be unrealistically overstated compared to public companies (or compared to other private companies that apply public company accounting) as a result of not recognizing amortization on those intangibles.

24. The FASB staff acknowledges that amortizing goodwill would represent an exception to current U.S. GAAP. However, a combination of allocating some or all intangibles to goodwill, and then requiring at least some portion of goodwill to be amortized, may be viewed as a practical expedient if the end result on the net assets of an entity is not materially different from today. If the PCC prefers a "practical expedient" alternative to this follow on issue, the FASB staff would have to further analyze the related costs and benefits.

**PCC Agenda Decision: *This issue was added to the PCC agenda. The scope of the issue is accounting for identifiable intangible assets acquired in a business combination. Subject to the PCC's decisions on this issue, subsequent accounting for goodwill may also be addressed.***

## **Appendix A**

### **Analysis of Draft Private Company Decision-Making Framework**

#### **Potential New Issue: Accounting for Identifiable Intangible Assets in a Business Combination**

##### Relevance to users (Paragraph 1.5 of Invitation To Comment (ITC) – PCDMF)

- a. Does the transaction, event, or balance affect reported cash balances, cash flows, or adjusted EBITDA?**

No, see also question (e) below.

- b. Does the transaction, event, or balance significantly affect borrowings, liquidity, or leverage?**

No.

- c. Does the transaction or event affect, or does the balance relate to, trade receivables, inventories, fixed assets, other long-term tangible assets, accounts payable, or other liabilities?**

No.

- d. Do users typically consider the quantitative effect of the transaction, event, or balance when evaluating collateral, financial performance, or financial position? Consider whether users typically adjust financial statements by substituting an alternative accounting approach.**

No. Users generally disregard intangible assets, as well as related amortization from their quantitative analyses.

- e. Is the primary purpose of the guidance to provide information about historical events and transactions rather than to provide information with predictive value to help users in making their forecasts of future cash flows?**

Intangible assets are measured based on their estimated fair values, as determined in a transaction in which consideration is exchanged at that time. Some intangible asset balances (for example, customer relationships) may provide some information about potential future cash flows. However, many users indicate that this information is not highly predictive in helping them making their cash flow forecasts.

- f. Does the guidance require that the threshold for recognizing or measuring a transaction or event be at least probable of occurring?**

No.

- g. Does the guidance relate to loss contingencies or commitments that could significantly affect future cash flows? If yes, consider whether disclosing the event or circumstance would likely satisfy the needs of users.**

No.

- h. Does the measurement guidance reflect volatility in financial statements resulting from underlying changes in market prices of debt instruments or certain derivatives that can reverse in the future because the instrument or derivative has a defined maturity or term?**

No.

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

Yes. Some users may have the ability to access management. Management would be able to provide more up to date information, for example, about its future potential cash flows from a customer contract, than the amounts reported in the financial statements.

- j. Is an untimely issuance of financial statements likely to significantly dilute the relevance of the information resulting from the guidance?**

No.

**Cost and Complexity (Paragraph 1.6 of ITC – PCDMF)**

- k. Does application of the guidance often require assistance from outside resources at a significant cost?**

Yes, many private companies incur significant external costs related to the initial recognition of intangibles acquired in a business combination. Valuation specialists are often engaged when valuing intangibles.

**l. Is significant complexity involved in determining the initial and/or ongoing accounting treatment?**

Yes, intangible assets acquired in a business combination are required to be measured at fair value. Many intangible assets require the use of unobservable input, which can require significant judgment.

**m. Are there expected to be significant changes to information systems, debt covenant agreements, other contracts, internal controls, or processes as a result of applying the new guidance?**

N/A. This is not new guidance.

**n. Is the accounting treatment challenging to audit, review, or compile?**

Yes, for reasons noted above.

**Other**

**o. Is the issue related to a current FASB project? If so, is there a pressing need to provide related guidance on a timelier basis than that expected from the FASB's activities?**

No.

**Private Company Council**  
**Description of Potential New Issue**  
**Discussion Date: February 12, 2013**

**Issue 2: Private Company Accounting for Variable Interest Entities**

**Background**

*History of VIE Guidance*

1. Guidance on consolidations was first issued in AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB 51), in August 1959. The traditional reason for consolidation described in ARB 51 was, "for fair presentation when one of the companies in the group directly or indirectly has controlling financial interest in the other companies." ARB 51 explains that "the usual condition for a controlling financial interest is ownership of a majority voting interest."
2. The consolidation principle in ARB 51 is appropriate for entities for which *equity* grants its holders power—in essence, voting interest entities (VREs). Voting equity investors in a VRE generally absorb losses first and they can be expected to resist arrangements that give other parties the ability to significantly increase their risk or reduce their benefits. Voting equity investors within VREs generally have the power to determine the activities that most significantly impact the entity's economic performance (hereinafter referred to as "power") and have an obligation to absorb losses or the rights to receive benefit (hereinafter referred to as "economics").
3. However, when an entity is not controlled by voting interest or lacks sufficient equity to finance the activities of the entity without additional subordinated financial support, the usual condition for establishing controlling financial interest under ARB 51 does not apply. In such instances, controlling financial interest is most likely established through interests other than equity, as is the case with VIEs.
4. Therefore, FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46R), was issued to provide guidance on how to identify VIEs and to

determine when consolidation of a VIE is necessary. Major revisions to the VIE model were issued through FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, in June 2009. Currently, VIE guidance is codified in Subtopic 810-10, Consolidations—Overall.

*VIE Guidance in a nutshell (Current Statement 167 Model)*

5. The introduction of VIE guidance did not change the VRE model; however, it added a layer of complexity. To retain the VRE model, the consolidation model was modified to first determine whether an entity is a VIE.

6. To do so, a reporting entity is required to determine whether it has a variable interest in an entity. Simply put, a variable interest is something that generally absorbs the risk and rewards created by an entity (for example, traditional equity and debt guarantees are considered to be variable interests).

7. If a reporting entity has a variable interest, then the reporting entity must assess whether the entity is a VIE. Conceptually, a VIE is an entity in which controlling financial interest is established through interests other than equity. The VIE model considers an entity to be a VIE if the equity investment at risk has *any* one of the following characteristics (paragraph 810-10-15-14):

- a. The entity is thinly capitalized (that is, equity is not sufficient to fund the entity's activities without additional subordinated financial support)
- b. The equity holders as a group lack the "power" or exposure to "economics" of the entity
- c. The equity holders have (1) voting rights that are not proportional to their obligation to absorb losses or their right to receive expected residual returns and (2) substantially all of the entity's activities either involve or are conducted on behalf of the equity investor with disproportionately few voting rights.

8. If a reporting entity has a variable interest in a VIE, then the reporting entity must determine whether it is the primary beneficiary of the VIE (that is, the reporting entity that consolidates the

VIE). The primary beneficiary is defined as the variable interest holder (or related party group) that has (a) the power to direct the activities that most significantly affect the economic performance of the VIE, and (b) the obligation to absorb losses or the right to receive benefits of the VIE that could be potentially significant to the VIE (paragraph 810-10-25-38A). While performing the primary beneficiary assessment, the reporting entity should also consider the interests held by the reporting entity's related parties. Therefore, in some circumstances the primary beneficiary could be the reporting entity's related party group taken as a whole instead of just the reporting entity. In those situations, if no single party within the related party group on its own meets both the power and economics criteria, the determination of the primary beneficiary is based on an assessment to determine the party that is most closely associated with the VIE (generally referred to as the related party tie-breaker test).

*Implicit Variable Interest and Related Party Leasing Arrangements:*

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

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

10. The guidance in FSP FIN 46(R)-5 (codified in paragraphs 810-10-25-48 through 25-54, and paragraphs 810-10-55-88 through 55-89) was intended to provide additional guidance for identifying implicit variable interest. FSP FIN 46(R)-5 provided the following example of an implicit variable interest:

One of the two owners of Manufacturing Company is also the sole owner of Leasing Company, which is a VIE. The owner of Leasing Company provides a guarantee of Leasing Company's debt as required by the lender. Leasing Company owns no assets other than the manufacturing facility being leased to Manufacturing Company. The lease, with market terms, contains no explicit

guarantees of the residual value of the real estate or purchase options and is therefore not considered a variable interest under paragraph B24 of Interpretation 46(R). The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Company and Leasing Company.

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

11. In the memorandum, the staff also stated that without the guidance in FSP FIN 46(R)-5, there would exist a great deal of opportunity to circumvent the application of FIN 46(R) by structuring a transaction to directly protect the interest holder in a VIE as opposed to the VIE itself. FSP FIN 46(R)-5 suggests that the Manufacturing Company (or "Operating Company") may have an implicit guarantee on Leasing Company's debt (that is, a variable interest in Leasing Company). If Manufacturing Company has an implicit variable interest (that is, a guarantee on the debt) and the Leasing Company is a VIE, then the Manufacturing Company and its owner as a related party group is generally considered to be the primary beneficiary.

12. Under the legacy FIN 46(R) model, the parties of the related party group (the Manufacturing Company and the owner) must perform a related party tie-breaker assessment to identify the primary beneficiary within the group. In principle, the tie-breaker assessment is based on identifying the party that is most closely associated with the VIE. Paragraph 810-10-25-44, which originated from Statement 167 and is included in paragraph 14 below, lists the four criteria to consider in determining which party is most closely associated with the VIE. When performing the tie-breaker assessment, practitioners place heavier weighting on criterion (b); "the relationship and significance of the activities of the variable interest entity to the various parties within the related party group." As a result of criterion (b), the Manufacturing Company

is generally considered to be the primary beneficiary because the leasing activity primarily benefits the Manufacturing Company. As a result of the FSP 46(R)-5 example, many assumed that similar related party leasing arrangements should always result in the Manufacturing Company consolidating.

13. However, the VIE consolidation guidance as amended by Statement 167 requires that the individual parties within a related party group shall first separately consider whether there is a single party within the related party group that has the characteristics of power and exposure to economics on its own as though no related party group exists. Specifically, Statement 167 made the following amendments to FIN 46(R), which is now in paragraph 810-10-25-44 (additions are underlined and deletions are ~~struck~~ through):

~~If two or more~~ In situations in which a reporting entity concludes that neither it nor one of its related parties has the characteristics in paragraph 810-10-25-38A but, as a group, the reporting entity and its related parties (including the de facto agents described in the preceding paragraph) hold variable interests in the same VIE, and the aggregate variable interest held by have those parties would, if held by a single party, identify that party as the primary beneficiary characteristics, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary. The determination of which party within the related party group is most closely associated with the VIE requires judgment and shall be based on an analysis of all relevant facts and circumstances, including all of the following:

- a. The existence of a principal-agency relationship between parties within the related party group
- b. The relationship and significance of the activities of the VIE to the various parties within the related party group
- c. A party's exposure to the ~~expected losses~~ variability associated with the anticipated economic performance of the VIE
- d. The design of the VIE.

14. Therefore, the staff believes that under the revised VIE guidance issued by Statement 167, the Manufacturing Company and owner would assess whether they individually hold the power over the Leasing Company and have an economic exposure from the Leasing Company. Some

may conclude that the owner of the manufacturing and leasing company clearly meets both the power and exposure to economics criteria through its own interest in the Leasing Company and that the Manufacturing Company actually lacks the power criterion because the power is actually granted through the owner. Others continue to determine that the Manufacturing Company is the primary beneficiary.

*Current Leases Project*

15. The FASB and the International Accounting Standards Board (IASB) initiated a joint project to develop a new approach to lease accounting that would ensure that assets and liabilities arising under leases are recognized in the statement of financial position. The Boards tentatively decided that for short-term leases (a lease with a maximum term of 12 months or less, including options to renew) a lessee need not recognize lease assets or lease liabilities.

16. For related party leasing arrangements, the Board tentatively decided not to provide specific guidance on recognition and measurement. The Board tentatively decided to emphasize the requirements for related party disclosures with, at a minimum, a link to current related party guidance.

17. To the extent a related party leasing arrangement is not consolidated, reporting entities would follow leasing guidance effective at the time. Under the proposed leasing model, this could result in recording a right of use asset and lease liability depending on the terms and conditions of the legal arrangement.

*Preliminary Feedback Received from Private Company Stakeholders on the Application of VIE Guidance*

18. The staff has received preliminary feedback from private company stakeholders through various channels including:

- a. Comment letters related to the exposure draft of FSP FIN 46(R)-5
- b. Nonpublic entity roundtables

- c. Written submissions to the Blue-Ribbon Panel on Standard Setting for Private Companies in 2010
- d. Private Company Financial Reporting Committee (PCFRC).

*Feedback - Overall VIE Guidance User Relevance*

19. Private company user constituents generally believe that consolidation should be a high hurdle. In other words, unless it is clearly evident that an entity's rights provide the entity with the ability to control another entity, users of private company financial statements typically do not support consolidation.

20. Most private company constituents find VIE guidance to be unduly complex and costly to implement. Furthermore, many private company constituents state that VIE guidance is difficult to follow and is fragmented—especially as written in Subtopic 810-10. Often times, if not always, the application of VIE guidance requires assistance from outside resources at a significant cost.

*Feedback – VIE Guidance for Related Party Leasing Entities*

21. While the feedback on VIE guidance has been broad, one area that most private company constituents focused on was applying VIE guidance to related party leasing entities. The most typical example cited is one that mirrors the example provided in FSP 46(R)-5 as discussed in paragraph 11 above.

22. Private company constituents state that the primary purpose of establishing a separate leasing company is for tax and estate planning purposes—not to structure off balance sheet debt. All relevant parties are generally aware of the leasing company and understand its purpose.

23. In instances in which the leasing company is consolidated based on VIE guidance, the primary users of private company financial statements, lenders, stated that consolidation is not relevant to them because they focus on the cash flows and tangible worth of their borrower's legal entity, as opposed to their borrower's reporting entity for U.S. GAAP purposes. Moreover, lenders generally do not request consolidated financial statements because they desire to evaluate

the individual performance of the borrowing entity. Consequently, if a lender receives consolidated financial statements, it usually requests a "consolidating" schedule. Users also noted that the operating company's disclosures are generally robust and provide sufficient information on the related party leasing arrangement.

24. Some private company users, such as sureties, find consolidation of related party leasing entities to be useful. However, sureties have expressed the most interest in the terms of the debt issued under the leasing company; this is especially true when the performance of a bonded project relies on collateralized equipment or property held under the leasing company. Sureties have also stated that robust disclosure could be sufficient in instances in which the related party leasing entity is not consolidated.

### **Scope**

25. This issue applies to private companies applying the provisions of the variable interest entity guidance in Subtopic 810-10.

### **Accounting Issue and Alternatives**

26. The FASB staff identified the following potential alternatives. These alternatives are not intended to be all inclusive. The FASB staff will provide a more comprehensive study of alternatives and implications to be considered at a future meeting by the PCC. Appendix A provides additional analysis of this issue considering the draft Private Company Decision Making Framework, as well as some other considerations. The FASB staff also notes that the following alternatives could be complemented with implementation guidance to assist private companies in applying the alternatives:

- a. *Alternative 1 (Scope Exception)*—provide private companies with a scope exception from applying VIE guidance in related party leasing arrangements in which no explicit variable interest is identified, but require additional disclosures about the related party leasing arrangement.

- b. *Alternative 2 (Related Party Tie Breaker)*—Provide clarification on how to apply the related party tie breaker test through a related party leasing example that would provide guidance as to when the owner can be considered as the primary beneficiary.
- c. *Alternative 3 (Simplify the entire VIE Model)*—simplify the entire VIE consolidation model within Subtopic 810-10 for private companies.

*Alternative 1 – Scope Exception*

27. Alternative 1 would exempt private companies from applying VIE guidance in Subtopic 810-10 to related party leasing companies when the only contract that exists between the operating company and the related party leasing company is the lease contract. Under this approach, more robust disclosures surrounding the leasing company and its debt would be required.

28. Proponents of this alternative believe that it would remove the complexities in applying VIE guidance for preparers and practitioners while providing pertinent information to the users of private company financial statements. This alternative could provide immediate relief to private companies, which many perceive to be long overdue. Furthermore, this alternative will likely reduce audit costs associated with related party leasing companies. Under this approach, the audit effort will likely focus on the leasing arrangement and debt held at the leasing company.

29. Opponents of Alternative 1 believe that another scope exception would be difficult to define and would further complicate the VIE model. As the scope exception would only apply to a narrow set of circumstances, the FASB staff is unsure whether this scope exception would provide relief to a significant number of related party leasing arrangements commonly found in the private company sector.

*Alternative 2 – Related Party Tie Breaker*

30. Alternative 2 is based on a recommendation to provide more clarity on how to apply the related party tie breaker test. Alternative 2 would retain the example in FSP 46(R)-5 and the operating company would likely continue to have an implicit variable interest in the leasing company. If the leasing company is assessed to be a VIE, the related party tie breaker test would

conclude that the owner is the primary beneficiary and the operating company would not require consolidation. While this would not require consolidation of the leasing company, VIE disclosures prescribed in Statement 167 would still be required.

31. Alternative 2 shares many of the same "pros" with Alternative 1. Some proponents also believe that this alternative does not change VIE guidance, instead, it provides clarity on applying the related party tie breaker in situations commonly found in the private company sector. Many argue that the VIE disclosures are not considered to be burdensome in this situation because many private company constituents already provide related party disclosures that are similar to the VIE disclosures. Some private company constituents stated that the assessment of a leasing company would be very simple under Alternative 2. Those constituents stated that they would automatically assume that the leasing company is a VIE and disclose whatever is required without performing a comprehensive VIE assessment.

32. Alternative 2 would result in an amendment to Topic 810 and would relate to both public and private companies. A drawback to Alternative 2 is that it requires further study to determine whether there are any unintended consequences of providing such an example.

*Alternative 3 – Simplify the entire VIE Model*

33. The primary issue under a broad project to address the VIE consolidation model is the fact that VIE guidance is considered to be complex and costly to apply for private companies. However, the same argument could be made for public companies. To simplify VIE guidance, the FASB staff believes that the entire VIE model would have to be reassessed, which could result in a complete overhaul of VIE guidance.

34. Currently, the VIE model is broad and applies to many different situations. Therefore, any change to the consolidation model (including an overhaul) could unintentionally change or increase complexity for private companies. Such a broad-based project would require a significant investment of research and time to determine the most appropriate way to simplify the model.

35. Furthermore, the Board currently has on its technical agenda a project addressing consolidations as it relates to the principal versus agent assessment. A concurrent project to overhaul VIE guidance for private companies could be counterproductive.

*Framework analysis for Alternatives 1 and 2 (Narrow-Scoped Alternatives)*

36. The FASB staff evaluated VIE guidance in Subtopic 810-10 for related party leasing arrangements under the recognition and measurement module of the draft Private Company Decision Making Framework (Framework) to determine whether the VIE guidance provides relevant information to the users of private company financial statements at a reasonable cost. The staff notes that the Framework places more weight on the overall response to questions that address user relevance.

37. The *primary* users of private company financial statements (lenders) have stated that they do not find consolidating a related party leasing company with an operating company to be useful. Most private company lenders believe that the consolidation of the leasing company distorts the financial statements of the operating company. These users often have to make adjustments to the operating company's financial statements for their analysis by requesting a "consolidating" schedule. Some users, generally sureties, state that they find consolidation of related party leasing entities to be useful. However, sureties have expressed the most interest in the terms of the debt issued under the leasing company. Overall, the FASB staff believes that VIE guidance for related party leasing arrangements does not provide user-relevant information.

38. The FASB staff noted that VIE guidance for related party leasing arrangements would meet most of the cost and complexity criteria discussed in paragraph 1.6 (Appendix A) of the Framework. In other words, the staff believes that VIE guidance for related party leasing arrangements is costly and complex to implement.

39. Since the FASB staff believes that VIE guidance for related party leasing arrangements does not provide user-relevant information and is costly and complex to apply, the staff believes that there is a sufficient basis to consider an exception or modification to VIE guidance.

*Framework analysis for Alternative 3*

40. The FASB staff did not perform an analysis for Alternative 3 (*simplify the entire VIE model*). As VIE guidance pertains to an entity for which controlling financial interest is established through interests other than equity, it would be difficult to argue that the guidance is not relevant to private companies in all instances. Qualitatively, the staff believes that VIE guidance is relevant to the users of private company financial statements; however, there may be situations in which VIE guidance produces a result that is not considered to be relevant. For example, when VIE guidance is applied to related party leasing arrangements.

41. Similar to the analysis performed for Alternatives 1 and 2, the FASB staff believes that VIE guidance would meet most of the cost and complexity criteria discussed in paragraph 1.6 of the Framework. In other words, the staff believes that VIE guidance is too costly and too complex to implement.

**PCC Agenda Decision:** *This issue was added to the PCC agenda. The PCC directed the FASB staff to analyze the application of variable interest entity guidance in related party arrangements for private companies in scoping the issue.*

## **Appendix A**

### **Analysis of Draft Private Company Decision-Making Framework**

#### **Potential New Issue: Private Company Accounting for Variable Interest Entities**

##### **Relevance to users (Paragraph 1.5 of ITC – PCDMF)**

- a. Does the transaction, event, or balance affect reported cash balances, cash flows, or adjusted EBITDA?**

Users (primarily lenders) have stated that consolidation of leasing companies do not provide them with relevant information. Users are interested in cash flows and tangible worth of the borrower's legal entity, which is generally the operating company.

Some users, generally sureties, state that they find consolidation of related party leasing entities to be useful. However, sureties have expressed the most interest in the terms of the debt issued under the leasing company.

- b. Does the transaction, event, or balance significantly affect borrowings, liquidity, or leverage?**

Refer to response in question (a).

- c. Does the transaction or event affect, or does the balance relate to, trade receivables, inventories, fixed assets, other long-term tangible assets, accounts payable, or other liabilities?**

Refer to response in question (a).

- d. Do users typically consider the quantitative effect of the transaction, event, or balance when evaluating collateral, financial performance, or financial position? Consider whether users typically adjust financial statements by substituting an alternative accounting approach.**

Refer to response in question (a)

- e. Is the primary purpose of the guidance to provide information about historical events and transactions rather than to provide information with predictive value to help users in making their forecasts of future cash flows?**

No.

- f. Does the guidance require that the threshold for recognizing or measuring a transaction or event be at least probable of occurring?**

No.

- g. Does the guidance relate to loss contingencies or commitments that could significantly affect future cash flows? If yes, consider whether disclosing the event or circumstance would likely satisfy the needs of users.**

No. While the leasing company's debt could ultimately become a commitment of the operating company based on decisions made by the owner, it is unlikely the operating company's debt agreement would permit that to happen if it would significantly affect the operating company's future cash flows.

- h. Does the measurement guidance reflect volatility in financial statements resulting from underlying changes in market prices of debt instruments or certain derivatives that can reverse in the future because the instrument or derivative has a defined maturity or term?**

No.

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

Yes. It is likely that primary users (lenders) that are interested in the Leasing Company could obtain information directly from management. However, based on outreach performed, sureties have stated that they may not always have the same level of access to management as lenders.

- j. Is an untimely issuance of financial statements likely to significantly dilute the relevance of the information resulting from the guidance?**

No.

**Cost and Complexity (Paragraph 1.6 of ITC – PCDMF)**

- k. Does application of the guidance often require assistance from outside resources at a significant cost?**

Yes.

- l. Is significant complexity involved in determining the initial and/or ongoing accounting treatment?**

Yes.

- m. Are there expected to be significant changes to information systems, debt covenant agreements, other contracts, internal controls, or processes as a result of applying the new guidance?**

N/A – not new guidance.

- n. Is the accounting treatment challenging to audit, review, or compile?**

Yes. VIE guidance is viewed as complex and requires judgment to apply.

**Overall**

- o. Is the issue related to a current FASB project? If so, is there a pressing need to provide related guidance on a timelier basis than that expected from the FASB's activities?**

Yes, there are two active projects on the FASB technical agenda that could impact this potential PCC agenda issue:

*1. Consolidations*—while there is currently an active project on the FASB technical agenda for consolidations, it relates to the principal versus agent assessment. While the principal versus agent assessment could affect related party leasing arrangements, the focus isn't on such issues.

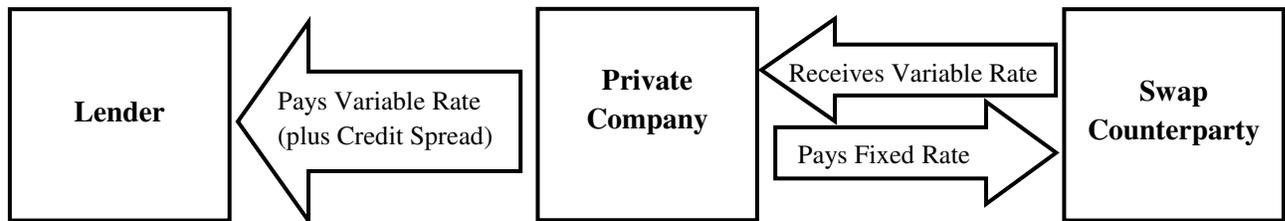
*2. Leases*—the Board anticipates issuing an exposure draft for leases in the first quarter of 2013. The new approach to lease accounting would ensure that assets and liabilities arising under leases are recognized in the statement of financial position. The leasing guidance could affect related party leasing transactions to the extent consolidations guidance does not apply.

**Private Company Council**  
**Description of Potential New Issue**  
**Discussion Date: February 12, 2013**

**Issue 3: Accounting for Receive Variable-Pay Fixed Interest Rate Swaps**

**Background**

1. Private companies often enter into receive variable-pay fixed interest rate swaps to economically convert a portion (or all) of their variable-rate debt to fixed-rate debt. Under U.S. GAAP, an interest rate swap is a derivative instrument. In a receive variable-pay fixed interest rate swap, an entity will receive a variable rate and pay the swap counterparty a fixed rate on the notional amount of the swap. The variable rate paid on the debt is offset by the variable rate received from the swap counterparty; however, the company still has to pay the agreed fixed rate on the swap (and any credit spread on the debt). Therefore, as illustrated below, in effect, the interest rate swap fixes the interest rate associated with the debt and mitigates the exposure to the risk of changes in cash flows due to changes in interest rates.



2. 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. However, to mitigate the income statement effect of recording an interest rate swap on the balance sheet at fair value, Topic 815 permits an entity to apply "cash flow hedge" accounting. A cash flow hedge is a hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk (for example, interest rate risk).

3. In cash flow hedge accounting, paragraph 815-20-35-1 provides that (a) the effective portion of the gain or loss on a derivative instrument designated in a cash flow hedge is initially reported in other comprehensive income, (b) the ineffective portion is reported in earnings, and (c) amounts in accumulated other comprehensive income are reclassified into earnings in the same

period or periods during which the hedged forecasted transaction affects earnings (for example, when a forecasted interest payment is charged to earnings). For a perfectly-matching, receive variable-pay fixed interest rate swap and a variable-rate debt, the above accounting results in presenting interest expense in the income statement as if the entity had issued a fixed-rate debt.

4. However, to qualify for cash flow hedge accounting, Section 815-20-25 indicates that certain criteria must be met, including:

- a. Formal designation and timely documentation at hedge inception
- b. Identification of the hedged transaction(s)
- c. Identification of the hedging instrument(s)
- d. Nature of the risk being hedged
- e. How the hedging instrument's effectiveness in offsetting exposure to variability in cash flows will be assessed.

5. Timely documentation and formal designation of a hedging relationship is critical to qualify for hedge accounting and should be established at the inception of the hedge (that is, contemporaneously). The hedge documentation should be detailed and comprehensive. Many private companies lack the expertise to comply with those documentation requirements and/or the resources to prepare the documentation timely (that is, contemporaneously).

6. To qualify for hedge accounting, the hedging relationship must be expected to be highly effective both at the inception of the hedge and on an ongoing basis. An assessment of hedge effectiveness is required whenever financial statements or earnings are reported and at least every three months. An entity must also consider hedge effectiveness prospectively and retrospectively. If certain other criteria are met, current GAAP permits the use of a qualitative method (known as the shortcut method) to assess hedge effectiveness for qualifying hedging relationships of interest rate risk. The shortcut method is based on an assumption of no ineffectiveness. An assumption of no ineffectiveness is especially important in a hedging relationship involving an interest-bearing financial instrument and an interest rate swap because it significantly simplifies the computations necessary to make the accounting entries.

7. The criteria for the shortcut method provided in paragraphs 815-20-25-102 through 25-111 include:

- a. The notional amount of the interest rate swap matches the principal amount of the interest bearing asset or liability being hedged.
- b. The fair value of the interest rate swap at the inception of the hedging relationship is zero.
- c. The interest-bearing asset or liability is not prepayable, that is, able to be settled by either party before its scheduled maturity.<sup>1</sup> If the hedged item is prepayable, the hedging instrument must have a mirror-image offsetting option.
- d. The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship.<sup>2</sup>
- e. The repricing dates of the swap match those of the variable-rate asset or liability.
- f. Other terms in the interest rate swaps are both typical of those instruments and do not invalidate the assumption of no ineffectiveness.

8. In practice, many private companies find that they do not qualify for the shortcut method for various reasons such as the repricing dates of the debt and swap do not match, the debt is prepayable at an amount other than its fair value without the hedging instrument having an offsetting matching option, or because interest payments are not based on a benchmark interest rate. In addition, because of the strict interpretation of the criteria, for instance, the verb "match" is used to mean "be exactly the same or correspond exactly"; there does not appear to be a concept of *close enough*. As a result, the long haul method to assess hedge effectiveness would have to be used. Because of limited resources and/or their difficulty in understanding and applying a long haul method if the shortcut method cannot be used for assessing effectiveness,

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<sup>1</sup> Paragraphs 815-20-25-112 through 25-115 provide guidance on what provisions are considered prepayable for the purposes of applying the shortcut method.

<sup>2</sup> In the U.S., currently only the interest rates on direct Treasury obligations of the U.S. government and, for practical reasons, the London Interbank Offered Rate swap rate are considered benchmark interest rates under Topic 815. There is an ongoing EITF Issue to also include the Fed Funds Effective Swap Rate as a benchmark rate.

many private companies find the requirements for assessing hedge effectiveness at inception and on a periodic basis burdensome.

*Preliminary feedback of private company constituents*

9. Since the issuance of the derivatives and hedge accounting guidance, many private companies have voiced concern regarding the accounting for interest rate swaps. The FASB staff has received feedback from private company stakeholders through various channels, including:

- a. Comment letters to the Invitation to Comment - Private Company Decision-Making Framework.
- b. Nonpublic entity roundtables.
- c. Written submissions to the Blue-Ribbon Panel on Standard Setting for Private Companies in 2010, and the FAF's Plan to Establish a Private Company Standards Improvement Council in 2011.
- d. Private Company Financial Reporting Committee (PCFRC).

Those private company concerns can be grouped into two broad categories discussed below.

*Category 1 – Swap with one counter party*

10. Private companies in this category commonly encounter the following situation:

A private company desires to enter into a fixed-rate debt; however, it often can only obtain variable-rate financing. Therefore, it enters into a plain-vanilla interest rate swap to obtain something economically equivalent to fixed-rate debt. Often times, private companies enter into the interest rate swap in which the lender commonly is the counterparty or serves as an intermediary between the counterparty and the borrower. This same lender is also requiring the private company to issue U.S. GAAP statements. Often, the lender provides the private company with the swap's fair value to comply with current GAAP. In those situations the lender is also the primary user of the financial statements.

11. Private company constituents within Category 1 have stated that private companies generally do not terminate and settle an interest rate swap before its maturity because their intent

is to obtain something economically equivalent to fixed-rate financing. Those constituents have also raised concerns about the marked difference between the accounting treatment for fixed-rate debt and the accounting treatment for variable-rate debt coupled with an interest rate swap, which they believe are economically equivalent.

12. The primary users (lenders) in Category 1 have stated that they do not find the fair value of the interest rate swap to be useful or relevant—especially when the users are the ones providing the fair value information to the preparers. Private company constituents have shared their concerns about the additional cost for management to validate the computation and for their accountants to audit the fair value of the swap, because that generally requires a valuation specialist.

13. Many private companies lack the accounting resources or expertise to document and comply with hedge accounting. As a result, the change in fair value of the swap flows through the income statement. Users stated that they ignore and often times reverse the effects of changes in the fair value of the swap on earnings in the financial statements.

Category 2 – multiple swaps with multiple counterparties

14. Private companies in this category commonly encounter the following situation:

Private companies in this category enter into multiple variable-to-fixed interest rate swaps with multiple counter parties to effectively convert a portion (or all) of their variable-rate debt into fixed-rate financing.

15. In those situations, some users of the financial statements have stated that they find the information about the fair value of the interest rate swap to be relevant, especially in situations in which the swap is at a significant liability position. Similar to Category 1, most private companies in this category do not have the accounting resources or expertise to document and comply with hedge accounting. Preparers shared their concerns about contemporaneous documentation requirements, the periodic assessments of hedge effectiveness, the strict requirements to qualify for the shortcut method, and their difficulty in understanding the long haul methods. As a result, many private companies in those situations do not elect or qualify for

hedge accounting, and, therefore, the change in fair value of the swap flows through their income statements, resulting in volatility.

16. Although Category 2 constituents may find information about the fair value of the interest rate swap to be relevant in some circumstances, they do not believe that the income statement volatility resulting from the current accounting of interest rate swaps is useful. They generally ignore that volatility in earnings and reverse the effects of changes in fair value of the swap on earnings.

### **Scope**

17. This issue applies to private companies applying the provisions of Topic 815.

### **Accounting Issues and Alternatives**

**Issue: How a private company should account for receive variable-pay fixed interest rate swaps.**

18. The FASB staff has identified the following preliminary alternatives to current guidance on accounting for derivatives. The staff will provide a more comprehensive study of alternatives and implications to be considered by the PCC at a future meeting. Appendix A provides additional analysis of this issue in relation to the Private Company Decision Making Framework, as well as other considerations.

*Alternative A: Account for the interest rate swap using amortized cost, disclosing key terms, and, in certain circumstances, disclosing the fair value of the interest rate swap.*

19. Alternative A proposes to consider an alternative measurement basis for a receive variable-pay fixed interest rate swap entered into by private companies in well-defined, limited circumstances. Under Alternative A, private companies would account for the receive variable-pay fixed interest rate swap at amortized cost, similar to the accounting for the underlying variable-rate debt. This alternative would result in a presentation that appears as if the entity had

entered into fixed-rate debt (similar to synthetic instrument accounting).<sup>3</sup> This alternative would include consideration of a footnote disclosure of the key terms and, in certain circumstances (for example, multiple variable-to-fixed interest rate swaps with multiple counter parties), the fair value of the interest rate swap.

20. Amortized cost treatment would result in:

- a. Recognizing the interest rate swap initially at cost and subsequently measure it at the accrual of the first next settlement if the net settlement amount is known at the reporting date (generally, the next settlement amount is known because it is based on rates reset at the beginning of or during the period, that is, rate resets are prospective instead of retrospective).
- b. The periodic income statement charge for the interest expense being equal to the amount that would result if the private company were to have entered into fixed-rate debt.
- c. Disclosing in the footnotes the key terms and possibly disclosing the fair value of the interest rate swap as of the reporting date, if users believe that this information is relevant to their analysis of the private company. As noted in the feedback above, many private company constituents argue that validating the computation and auditing of the fair value of the swap is burdensome and costly.

21. The different accounting and reporting treatment under Alternative A would have the following advantages:

- a. The income statement would reflect a fixed rate debt when the two instruments (the debt and the swap) are considered together as a unit.

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<sup>3</sup> Similar to Alternative A, paragraph 349 of the basis for conclusions of legacy Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, indicates that under synthetic instrument accounting, two or more distinct financial instruments (for example, a variable-rate debt and a receive variable-pay fixed rate swap) are viewed as having synthetically created another single financial instrument (for example, a fixed-rate debt).

- b. Volatility would be reduced in the income statement and users would no longer have to reverse the effects of changes in the fair value of the swap that otherwise have to be recognized in earnings under current GAAP when an entity does not elect or qualify for, and therefore does not apply, hedge accounting.
- c. The preparer would incur less cost, particularly if only the key terms and conditions and not the fair value of the swap are required to be disclosed in the footnotes.
- d. Users will not lose relevant information and yet have the benefit of the preparer reporting an amount of interest expense in the income statement that reflects the combination of the two instruments.

22. Some argue, however, that the drawbacks of Alternative A include the following:

- a. The amortized cost accounting of Alternative A may not be appropriate if, in subsequent reporting periods, the private company terminates the interest rate swap prior to maturity. If the swap is terminated early, the gain or loss on termination would have to be reported in current earnings. Under those circumstances, the off-balance-sheet treatment of the swap's fair value in prior reporting periods would be difficult to justify.
- b. The accounting under Alternative A would be similar to synthetic instrument accounting, which the FASB had earlier rejected at the time of issuing FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. In paragraph 350 of the basis for conclusions of that standard, the FASB stated that

...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."

- c. Some believe that the criteria for obtaining amortized cost treatment under Alternative A might be so narrow that it might not provide relief to a significant number of private companies.
- d. In the development of Alternative A, the PCC would have to decide on various scope issues, such as those indicated below, and considering the intricacies, it may be challenging to arrive at a determination:
  - i. Defining the circumstances when amortized-cost accounting should apply (for example, only for specific industries or types)
  - ii. Whether accounting should depend on the entity's intent to hold to maturity both the swap and the debt (even though, for example, the swap may be in a gain position prior to maturity).

*Alternative B: Simplify hedge accounting.*

23. The objective of Alternative B is to make it easier for private companies to qualify for hedge accounting for receive variable-pay fixed interest rate swaps and, thus, avoid volatility in the income statement.

24. Under Alternative B, private companies would not change the measurement basis or the accounting for interest rate swaps. A simplified hedge accounting model would have to be developed, although certain hedge accounting provisions in other guidance could potentially be considered, for example, Governmental Accounting Standard No. 53, *Accounting and Financial Reporting for Derivative Instruments* (GAS 53), and International Financial Reporting Standards (IFRS) for Small and Medium-Sized Entities (SMEs). The PCC also could consider adopting some of the simplification concepts included in the FASB's May 2010 Exposure Draft, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*.

25. Further research would have to be conducted to determine what types of receive variable-pay fixed interest rate swaps would qualify under Alternative B. A simplified hedge accounting approach could, for example, provide relief from the contemporaneous documentation (for

example, provide more time for the documentation and/or reduce the documentation requirements) and make it simpler to be eligible to apply a qualitative method (similar to the shortcut method) that assumes no ineffectiveness if certain criteria are met.

26. The advantages of Alternative B include the following:

- a. Private companies would not have to wait for the completion of the broader FASB project on accounting for derivative instruments and hedging activities. The FASB staff is unclear about the timing and ultimate direction of the FASB project. Even if that project simplified hedge accounting, it would most likely take several years from now for the guidance to become effective.
- b. Many private companies have stated that they do not elect or are ineligible for hedge accounting under current GAAP because of its complexity and contemporaneous documentation and periodic effectiveness requirements. They would be able to qualify for hedge accounting under the simplified approach and, thus, provided the simplified criteria are met, avoid the volatility in the income statement and assume no ineffectiveness in the hedging relationship. Assuming no ineffectiveness would significantly simplify the computations necessary to make the accounting entries and the private company would present interest expense in the income statement as if it had issued a fixed-rate debt.
- c. Since Alternative B would not change the measurement guidance for derivatives, the interest rate swap will be on balance sheet at fair value, thus providing transparency and comparability with public entities. Financial statement users will continue to have all of the relevant information even if, for example, the private company decides to terminate early either the interest rate swap or the underlying debt.

27. Some believe, however, that Alternative B would be difficult to justify as being only applicable to private companies. The complexity and cost arguments to simplify hedge accounting also apply to public companies, and, therefore, they believe that instead of the PCC proposing its own hedge accounting model, it should provide input to the Board on any issues that are unique to private companies as the Board redeliberates its broader project on accounting

for derivative instruments and hedging activities, which it expects to begin work on later this year. Depending on the approach used to simplify hedge accounting, the broader hedging project could conflict with the direction taken under this alternative. However, leveraging the concepts to simplify hedge accounting as proposed in the May 2010 Exposure Draft could mitigate that concern. Further, simplifying the hedge accounting model only for private companies would have its own challenges to address, including scope, comparability, and conceptual issues.

**PCC Agenda Decision:** *This issue was added to the PCC agenda. The PCC directed the FASB staff to more narrowly focus the issue on the accounting for receive variable-pay fixed interest rate swaps in which the lender is the counterparty to the swap or acts as an intermediary,. The PCC also directed the staff to continue research on interest rate swaps for which the lender is not the counterparty or does not act as an intermediary.*

## **Appendix A**

### **Analysis of Draft Private Company Decision-Making Framework**

#### **Potential New Issue: Accounting for Receive Variable-Pay Fixed Interest Rate Swaps**

##### **Relevance to users (Paragraph 1.5 of ITC – PCDMF)**

- a. Does the transaction, event, or balance affect reported cash balances, cash flows, or adjusted EBITDA?**

No. Based on feedback received, derivatives and hedge accounting adjustments do not form part of adjusted EBITDA, that is the effect due to the change in fair value of the interest rate swap on earnings in the income statement is generally reversed. Fair value changes do not affect reported cash balances or cash flows.

- b. Does the transaction, event, or balance significantly affect borrowings, liquidity, or leverage?**

No. Private companies rarely terminate and settle an interest rate swap before maturity. As such, a receive variable-pay fixed interest rate swap does not significantly affect the reporting entity's borrowing capacity, liquidity, or leverage.

However, entities could enter into interest rate swaps in different circumstances, which may affect their borrowing capacity, liquidity or leverage. For example, a requirement in the swap agreement to post collateral will affect the entity's liquidity.

- c. Does the transaction or event affect, or does the balance relate to, trade receivables, inventories, fixed assets, other long-term tangible assets, accounts payable, or other liabilities?**

No

- d. Do users typically consider the quantitative effect of the transaction, event, or balance when evaluating collateral, financial performance, or financial position? Consider whether users typically adjust financial statements by substituting an alternative accounting approach.**

No. In fact, many private company users stated that they reverse the effects due to the change in fair value of the interest rate swap on earnings in the income statement.

- e. Is the primary purpose of the guidance to provide information about historical events and transactions rather than to provide information with predictive value to help users in making their forecasts of future cash flows?**

No.

- f. Does the guidance require that the threshold for recognizing or measuring a transaction or event be at least probable of occurring?**

No.

- g. Does the guidance relate to loss contingencies or commitments that could significantly affect future cash flows? If yes, consider whether disclosing the event or circumstance would likely satisfy the needs of users.**

Yes. Private companies rarely terminate and settle an interest rate swap before maturity. However, if the terms of the swap are known, then users have the information to estimate future cash flows due to the debt and interest rate swap.

- h. Does the measurement guidance reflect volatility in financial statements resulting from underlying changes in market prices of debt instruments or certain derivatives that can reverse in the future because the instrument or derivative has a defined maturity or term?**

Yes.

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

Yes. It is likely that primary users (lenders) either have the information or could obtain relevant information from management.

- j. Is an untimely issuance of financial statements likely to significantly dilute the relevance of the information resulting from the guidance?**

No.

**Cost and Complexity (Paragraph 1.6 of ITC – PCDMF)**

**k. Does application of the guidance often require assistance from outside resources at a significant cost?**

Yes. Current hedge accounting guidance is complex and often requires outside assistance at a significant cost to account for interest rate swaps.

**l. Is significant complexity involved in determining the initial and/or ongoing accounting treatment?**

Yes. Many private company preparers (and even many public company preparers) have indicated their concern about the complexity of hedge accounting and the costs associated with accounting for interest rate swaps at fair value.

**m. Are there expected to be significant changes to information systems, debt covenant agreements, other contracts, internal controls, or processes as a result of applying the new guidance?**

Not Applicable.

**n. Is the accounting treatment challenging to audit, review, or compile?**

With respect to current accounting, generally, yes, because of extensive documentation and assessment of hedge effectiveness requirements. Many believe that current hedge accounting is difficult to understand and apply. Auditing fair values generally also requires a valuation specialist, which adds to the cost.

**Other**

**o. Is the issue related to a current FASB project? If so, is there a pressing need to provide related guidance on a timelier basis than that expected from the FASB's activities?**

Currently, reconsideration of accounting for derivative instruments and hedging is a part of the accounting for financial instruments (AFI) project. However, this part of the AFI project is currently on hold pending the outcome of the Classification and Measurement phase of the same standard. It is likely that work will begin on the hedging phase of the project later this year.

**Private Company Council**  
**Description of Potential New Issue**  
**Discussion Date: February 12, 2013**

**Issue 4: Accounting for Uncertain Tax Positions**

**Background**

1. The Board issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), in June 2006 (codified in Topic 740, Income Taxes). FIN 48 was initially effective for fiscal years beginning after December 15, 2006, for all entities. The Board issued FIN 48 to clarify the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes* (FAS 109). FIN 48 prescribed a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return.

2. The Board undertook the project because of concerns raised about diversity in practice in accounting for uncertainty in income taxes. The FASB received feedback from stakeholders that several different methods had developed in practice. Stakeholders noted that U.S. GAAP did not address how the uncertainty about whether a position taken on a tax return would be upheld should affect the amounts reported in the financial statements.

3. In the Master Glossary, a tax position is defined as "a position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods." Once an entity has identified its tax positions, it must assess its uncertain tax positions for tax years that are open to challenge by the relevant taxing authorities.

4. Codification paragraph 740-10-25-6 states that "an entity shall initially recognize the financial statement effects of a tax position when it is more-likely-than-not, based on the technical merits, that the position will be sustained upon examination." The recognition threshold of more-likely-than-not indicates a likelihood of more than 50 percent based on the "facts, circumstances, and information available at the reporting date." In assessing the more-likely-

than-not criterion, an entity shall presume that the taxing authority has full knowledge of all the relevant information and would evaluate each position without considering offsets or aggregation with other positions. Entities must identify and assess uncertainties related to deferred tax assets and liabilities based on the sustainability of the position. If it is more-likely-than-not that some or all of the deferred tax asset will not be realized, a valuation allowance is required.

5. Beginning in the tax year 2010, the Internal Revenue Service (IRS) required certain companies to include Schedule UTP<sup>1</sup> when those companies have recorded a reserve in their audited financial statements for uncertain tax positions. Schedule UTP must include the identification of the primary Code sections involved, a size ranking from largest to smallest, and a concise description of each tax position. For tax years 2010 and 2011, the IRS required companies with assets equal to or exceeding \$100 million to include Schedule UTP. The IRS dropped the asset threshold to \$50 million beginning in tax year 2012 and then again to \$10 million beginning in 2014. For tax year 2010, the IRS did not require a Schedule UTP from some Form 1120 series filers or from passthrough entities. In February 2012, the IRS revised instructions for the 2011 Schedule UTP to include, among other things, specific references to FIN 48.

#### **FASB's efforts to address nonpublic stakeholders' concerns**

6. Post-implementation, the Board clarified some aspects of FIN 48 and addressed certain issues noted by nonpublic entities.

- a. In May 2007, the Board issued FASB Staff Position No. 48-1, Definition of *Settlement* in FASB Interpretation No. 48, to provide guidance on how an enterprise should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits.
- b. In February 2008, in response to concerns raised by the Private Company Financial Reporting Committee (PCFRC) and other stakeholders, the Board issued FASB Staff Position No. FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain*

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<sup>1</sup> Form 1120 Schedule UTP and Instructions for Form 1120 Schedule UTP can be found in link <http://www.irs.gov/Businesses/Corporations/Uncertain-Tax-Positions---Schedule-UTP>

*Nonpublic Enterprises*, to delay the effective date of FIN 48 for one year for nonpublic entities in order to provide nonpublic entities with additional time to implement FIN 48.

- c. In December 2008, in response to a request by the PCFRC and other nonpublic entity stakeholders, the FASB issued FASB Staff Position No. FIN 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, to defer the effective date of FIN 48 for nonpublic entities by an additional year. FSP FIN 48-3 deferred the effective date for nonpublic entities to years commencing after December 15, 2008. The PCFRC asked the Board to consider an exemption for nonpublic entities from all requirements prescribed by FIN 48 and at a minimum to delay the effective date. The Board decided to delay the effective date so that (a) nonpublic entities would have more time to study and prepare to apply the requirements, (b) the FASB could provide additional guidance clarifying how FIN 48 should be applied to pass-through entities and not-for-profit organizations, and (c) the FASB could consider whether nonpublic entities should be exempt from some of the disclosure requirements contained in FIN 48.
- d. In September 2009, after consulting with nonpublic entity stakeholders and the PCFRC, the Board issued Accounting Standards Update No. 2009-06, *Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities* (ASU 2009-06), to provide implementation guidance on accounting for uncertain tax positions for pass-through entities and to exempt nonpublic entities from the most costly disclosure requirements contained in FIN 48. ASU 2009-06 exempted nonpublic entities from the requirement to disclose a tabular reconciliation of the gross amount of changes in unrecognized tax benefits of current and prior period tax positions, settlements with taxing authorities, and statute of limitations lapses. ASU 2009-06 also exempted nonpublic entities from disclosing the total amount of unrecognized tax benefits that would affect the effective tax rate had they been recognized.

### **Feedback from nonpublic stakeholders prior to the PCC Formation**

7. During the 2010 deliberations of the AICPA/FAF/NASBA Blue-Ribbon Panel on Standard Setting for Private Companies, respondents providing written submissions expressed concern that certain accounting requirements in the area of income taxes and uncertain tax positions were

problematic and that the Board should revisit those issues with respect to private companies. The Blue Ribbon Panel took place while many nonpublic entities were in the process of implementing FIN 48 for the first time.

8. Blue-Ribbon Panel respondents disagreed with the FIN 48 approach because it assumes all uncertain tax positions are examined by the taxing authority, whereas the loss contingencies model (under FASB Statement No. 5, *Accounting for Contingencies*) factors in detection risk (that is, the likelihood of actual examination). Respondents were concerned about the more-likely-than-not threshold for recognizing the benefit of uncertain positions. Both private and public company stakeholders expressed concern that the disclosures required by FIN 48 provide a "roadmap" for the IRS. The Board exempted private companies from the most contentious disclosures, as described above. However, some private company stakeholders continue to voice general objections to the requirements of FIN 48, most recently at the Small Business Advisory Committee meeting on January 25, 2013, because they believe the required information would provide a "roadmap" for the IRS. (As noted above, the IRS is now requiring information about uncertain tax positions recorded in audited financial statements to be included with tax filings.)

9. During the private company roundtables conducted by the FASB on October 12, 2010 and November 2, 2010, participants focused on the lessons to be learned from the FIN 48 experience. Specifically, participants noted that the Board should have considered the implications to private companies from the project's onset and issued the pass-through entity guidance (subsequently issued in ASU 2009-06) as part of the original pronouncement. Participants also stated that the original pronouncement should have delayed the effective date rather than subsequently extending the effective date just as the original pronouncement took effect. They believe that this would have allowed nonpublic entities more time to plan for implementation and to learn from the way public companies implemented FIN 48.

10. In March 2012, the Financial Accounting Foundation's (FAF) post-implementation review (PIR) team issued its public report on the effectiveness of FIN 48 in providing decision-useful information to investors and other financial statement users. Overall, the PIR team concluded that FIN 48 improved the reporting on income tax uncertainties for investors and other users. The

PIR team received feedback from nonpublic and not-for-profit stakeholders that FIN 48 is a good example of financial accounting standards-setting bias to large public company issues. These stakeholders believe that FIN 48 deals with issues generally not relevant to many nonpublic and not-for-profit entities.

11. The PIR team heard from stakeholders that nonpublic entities' views were not sought or considered thoroughly during the standard-setting phase of the initial project. Consequently, the FASB spent considerable time redeliberating nonpublic entity concerns after FIN 48 was issued. The FASB revised the effective date twice, which (according to participants of the FIN 48 PIR) made it difficult to get nonpublic entities to focus on implementing FIN 48 during the time the effective date was being reconsidered. The PIR team believes that earlier consideration of input from those stakeholders may have reduced FASB's deliberation time and the need to defer FIN 48's effective date for those entities. Since FIN 48 was issued, the Board has invested considerable time addressing private company and not-for-profit entity issues raised by such stakeholders.

12. The PCFRC (formed in 2007) focused considerable attention on identifying and recommending changes to FIN 48 to address private company concerns, as described above. The PCFRC was unable to attain an exemption from FIN 48 in its entirety for nonpublic entities from the Board. However, the effective date was extended for nonpublic entities twice and the Board provided an exemption for nonpublic entities from certain disclosure requirements contained in FIN 48. The Board also provided additional guidance for pass-through entities, further addressing concerns of nonpublic stakeholders.

13. The PCFRC provided a transition memorandum to the PCC, dated November 20, 2012, which stated:

While certain narrow issues remain with FIN 48 (Topic 740), we feel that these are lower priority items for the PCC and FASB.

**Recent outreach at the request of the PCC**

14. The PCC requested that the FASB staff perform some limited outreach to determine (a) what specific concerns nonpublic stakeholders have with the accounting model for uncertain tax positions and (b) what options are available to address those concerns.

15. In January 2013, the FASB staff conducted outreach calls with certain PCC members, which included users, preparers, and auditors.

16. Users believe that one recognition and measurement approach that can be applied consistently should be utilized. In addition, users thought disclosure of significant uncertain tax positions was important because of the inherent level of uncertainty associated with uncertain tax positions.

17. Preparers believe that the implementation of FIN 48 was very challenging. However, applying the requirements has become easier after preparers developed procedures for applying the recognition and measurement approach in FIN 48. In addition, preparers stated that much of the complexity in applying FIN 48 relates to complexity in the tax law. Preparers also stated that the incremental costs associated with applying FIN 48 on an ongoing basis are minor.

18. Auditors believe that most entities have learned how to apply FIN 48 and there are no significant remaining issues. They also stated that much of the complexity in this area involves complexity in the tax law.

19. In addition to this recent outreach, the FASB staff considered whether the Board has received any (a) formal agenda requests about the recognition and measurement approach in FIN 48 in recent years or (b) technical inquiries about the application of FIN 48. Since the time the Board updated some of the requirements in FIN 48, as described above, there have been no formal agenda requests and few technical inquiries. All of the technical inquiries since that time were straightforward and there were no technical inquiries received in 2012 or 2013 to date.

### **Options for moving forward**

20. Based on the limited outreach, the FASB staff recommended that the PCC consider the following two options.

#### *Option 1: Conduct more outreach*

- a. The PCC could conduct a more comprehensive outreach effort, including soliciting input from users, preparers, and auditors of nonpublic entities. Then the PCC could evaluate feedback received to determine whether a different recognition and measurement approach or additional disclosure exemptions for nonpublic entities is warranted that would provide users of financial statements with the information they require while reducing cost and complexity for preparers.
- b. One alternative approach to FIN 48 would be to account for an uncertain tax position like a loss contingency (FAS 5). However, due to the limited outreach, it is not clear to the staff whether such an approach would be beneficial to users or address preparers' concerns. In addition, it is not clear whether the cost to make a change would be worthwhile if there are no benefits to users and if preparers are not incurring significant incremental costs to apply FIN 48 after initial implementation. The staff also observes that users may want enhanced disclosure of uncertain tax positions if a loss contingencies approach is selected, which may not be viewed as favorable to preparers based on their feedback about the original disclosure requirements in FIN 48.
- c. Another alternative approach would be to provide additional disclosure relief under FIN 48 for private companies. However, it is not clear to the staff whether further disclosure exemptions would be favorable to users, reduce preparers' costs, or lessen concerns about providing a "roadmap" to the IRS. See paragraph 5 and the attachment about Form 1120 Schedule UTP that is required by the IRS.
- d. The staff believes that a project on this matter would require significant effort to develop a model, test the model with significant input from stakeholders, and then compare the model to the existing requirements in FIN 48 to determine whether it would be an enhancement to financial reporting for users of nonpublic entity financial statements and/or a significant reduction in costs for preparers.

*Option 2: Decide not to add a project to the PCC agenda at this time*

- e. The PCC could decide to not add a project to the PCC agenda at this time based on the limited outreach conducted so far, which resulted in no *specific* concerns being raised, and the lack of any new formal agenda requests and technical inquiries.

**PCC Agenda Decision:** *This issue was not added to the PCC agenda. While PCC members acknowledged the desire to continue to solicit feedback from stakeholders on this issue, no practice issues were identified that would require immediate attention.*

**Appendix A**  
**Analysis of Draft Private Company Decision-Making Framework**  
**Potential New Issue: Accounting for Uncertain Tax Positions**

**Relevance to users (Paragraph 1.5 of ITC – PCDMF)**

- a. Does the transaction, event, or balance affect reported cash balances, cash flows, or adjusted EBITDA?**

Yes. Uncertain tax positions involve cash outflows associated with income taxes, which can be significant for many nonpublic entities.

- b. Does the transaction, event, or balance significantly affect borrowings, liquidity, or leverage?**

Yes. Uncertain tax positions can impact an entity's liquidity, which is important to users of financial statements. In addition, the staff understands that users of financial statements are interested in a recognition and measurement approach that can be applied in a consistent manner and disclosures about uncertain tax positions.

- c. Does the transaction or event affect, or does the balance relate to, trade receivables, inventories, fixed assets, other long-term tangible assets, accounts payable, or other liabilities?**

No.

- d. Do users typically consider the quantitative effect of the transaction, event, or balance when evaluating collateral, financial performance, or financial position? Consider whether users typically adjust financial statements by substituting an alternative accounting approach.**

The staff has not performed enough outreach to answer this question.

- e. Is the primary purpose of the guidance to provide information about historical events and transactions rather than to provide information with predictive value to help users in making their forecasts of future cash flows?**

The guidance provides information about future cash outflows associated with uncertain tax positions that an entity has taken on its tax returns.

- f. Does the guidance require that the threshold for recognizing or measuring a transaction or event be at least probable of occurring?**

No. The FIN 48 model has a more-likely-than-not threshold. The FASB specifically considered a probable recognition threshold when it was deliberating FIN 48, and the FASB

initially selected a probable recognition threshold. However, stakeholders raised significant concerns about a probable recognition threshold, as described in the Basis for Conclusions for FIN 48.

- g. Does the guidance relate to loss contingencies or commitments that could significantly affect future cash flows? If yes, consider whether disclosing the event or circumstance would likely satisfy the needs of users.**

Uncertain tax positions can significantly affect future cash flows, depending on the extent of uncertain tax positions taken on tax returns. From the staff's outreach with users, a recognition and measurement approach that can be applied consistently is important. Therefore, the staff does not believe disclosure of uncertain tax positions alone would satisfy the needs of users. In addition, the staff believes that the level of disclosure that would be necessary to eliminate the recognition and measurement of uncertain tax positions (or significantly change the recognition threshold) would require far more disclosure than preparers would be comfortable with.

- h. Does the measurement guidance reflect volatility in financial statements resulting from underlying changes in market prices of debt instruments or certain derivatives that can reverse in the future because the instrument or derivative has a defined maturity or term?**

No.

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

The staff has not performed enough outreach to answer this question. However, the staff observes that the nonrecognition of uncertain tax positions could materially understate the liabilities of some entities.

- j. Is an untimely issuance of financial statements likely to significantly dilute the relevance of the information resulting from the guidance?**

No. Uncertain tax positions can be unresolved for many years or sometimes indefinitely.

**Cost and Complexity (Paragraph 1.6 of ITC – PCDMF)**

- k. Does application of the guidance often require assistance from outside resources at a significant cost?**

After implementation of FIN 48, the staff does not believe that the model requires significant incremental costs.

**l. Is significant complexity involved in determining the initial and/or ongoing accounting treatment?**

With respect to the accounting model itself, there is one recognition and measurement approach that can be applied consistently to all uncertain tax positions. However, the tax law is complex and this can make the accounting for uncertain tax positions challenging. Given the complexity that exists in the tax law, the staff believes that any recognition and measurement approach will involve complexity.

**m. Are there expected to be significant changes to information systems, debt covenant agreements, other contracts, internal controls, or processes as a result of applying the new guidance?**

The staff does not have enough information to answer this question.

**n. Is the accounting treatment challenging to audit, review, or compile?**

Uncertain tax positions may be challenging to audit, review, or compile because they require an understanding of tax laws, which are complex and may involve multiple jurisdictions with different tax laws. No recognition and measurement approach could eliminate this challenge

**Overall Question**

**o. Is the issue related to a current FASB project? If so, is there a pressing need to provide related guidance on a timelier basis than that expected from the FASB's activities?**

No.