

THE NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

# BDO KNOWS: PCC



## PRIVATE COMPANY ASUs AVAILABLE FOR 2013

### INTRODUCTION

The FASB recently completed three standards for private companies. The first new Accounting Standards Update (ASU) defines a public business entity. That definition determines which entities may be eligible for the accounting alternatives developed by the Private Company Council (PCC). The other two new ASUs represent the PCC's initial accounting alternatives for private companies. They are intended to simplify the accounting for goodwill and make it easier to apply hedge accounting to certain "plain-vanilla" interest rate swaps. Private companies will be able (but not required) to adopt the new standards for December 31, 2013 year-end financial statements that are not yet available for issuance. This financial reporting newsletter summarizes all three standards and also provides answers to frequently asked questions in the appendices.

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## ► DEFINITION OF A PUBLIC BUSINESS ENTITY (ASU 2013-12)

The Board decided to identify those entities that may be eligible to elect a PCC alternative through a process of elimination. That is, a reporting enterprise that meets the definition of a public business entity (a "PBE") is precluded from adopting a PCC alternative. However, all remaining entities are not automatically eligible. The Board will decide whether all, or only a subset of entities that are not PBEs, will be included within the scope of an individual PCC alternative. Specifically, financial institutions, not-for-profit entities and employee benefit plans will be evaluated on a standard-by-standard basis. As such, reporting entities interested in electing one or more PCC alternatives must first determine whether they meet the definition of a PBE. If not, they must determine if they are included in the scope of each individual PCC alternative, such as the new ASUs related to goodwill and interest rate swaps discussed below.

A PBE is an entity which meets any of the following criteria:<sup>1</sup>

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a PBE for purposes of financial statements that are filed or furnished with the SEC.

Readers are encouraged to review the basis for conclusions accompanying the definition of a PBE in ASU 2013-12, which provides important context. It can be accessed [here](#). For example, item (e) captures only securities that are not subject to contractual restrictions on transfer. In the basis for conclusions, the FASB noted that many private companies place restrictions on the sale of their securities in a secondary market (i.e., management preapproval is required). This allows the company to control who owns the securities. The second condition in item (e) should be construed broadly, including financial statements that are posted on a website or are simply available upon request. Consequently, unless an entity i) issues unrestricted securities and ii) is subject to a periodic filing requirement (e.g., interim or annual), it would not be considered public.

The basis for conclusions also indicates the following are considered PBEs:

- a. Broker dealers
- b. Equity method investees whose financial statements are including in a filing under Rule 3-09<sup>2</sup> of Regulation S-X
- c. Equity method investees whose financial information is included in a filing under Rule 4-08(g)<sup>3</sup> of Regulation S-X
- d. An acquired business whose financial statements are included in a filing under Rule 3-05<sup>4</sup> of Regulation S-X
- e. Entities whose securities trade on an over-the-counter (OTC) market, such as OTC Markets Group Inc., OTC Pink Markets or the OTC Bulletin Board.

With respect to items b-d, the FASB concluded the entities are considered PBEs in the context of another entity's filing. As such, the PCC alternatives should not be applied to financial information or financial statements that appear in any SEC filing. However, these entities are still permitted to apply PCC alternatives in their stand-alone financial statements, assuming they otherwise qualify as a private company. The same is true for a private company consolidated by a public parent. In addition, if a private company controls and consolidates a public company, the consolidated statements of that private company parent would be eligible for PCC alternatives even though the public subsidiary would not be eligible in its standalone statements.

<sup>1</sup> Neither a not-for-profit entity nor an employee benefit plan is a business entity.

<sup>2</sup> *Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons*

<sup>3</sup> *Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons*

<sup>4</sup> *Financial Statements of Businesses Acquired or To Be Acquired*

**► BDO COMMENT:**

Entities that are not public now (i.e., that do not qualify as PBEs) should carefully consider whether they may become public in the future. For example, a private company that initially elects one or more PCC alternatives and subsequently conducts an IPO would be required to “unwind” the accounting impact of the PCC alternatives in its historic financial statements for the initial registration statement. In other words, U.S. GAAP for public business entities would be retrospectively applied to all prior periods presented. This could require significant time and expense. The same treatment would apply to the financial statements of a private company whose owners sell their ownership interest to a larger public company. In the absence of further standards from the FASB or the SEC, there is no guidance provided for transition out of any PCC alternative. As such, a private company should consider the current and future needs of those who receive its financial statements, including banks and other lenders, before electing a PCC option.

In addition to the PCC, the new definition of a public entity will be used by the FASB and EITF to specify the scope of subsequent accounting standards. While the Board considered revisiting the scope of existing guidance that differs for public and private entities (e.g., segments and earnings per share), it concluded there was no pressing need to do so now but may revisit the issue in the future.

The definition of a PBE does not have an effective date. Other standards that use the term “public business entity” will specify the related effective date.

## ► ACCOUNTING FOR GOODWILL, A CONSENSUS OF THE PCC (ASU 2014-02)

**Summary:** Private companies now have the option of amortizing goodwill over ten years, or a shorter period if that period is more appropriate. Entities making the election will test goodwill for impairment only when a triggering event occurs, instead of annually. In that situation, entities will elect to perform the test either at an entity-wide level or the reporting unit level. The amount of impairment, if any, would be determined by comparing the fair value of the entity (or reporting unit) to its carrying amount. A hypothetical purchase-price allocation (also commonly referred to as “Step 2”) does not apply. ASU 2014-02 is available [here](#).

**Scope and Effective Date:** Under ASU 2014-02, a private company is an entity other than a not-for-profit entity, an employee benefit plan or a PBE. If elected, the accounting alternative should be applied prospectively to goodwill existing as of the beginning of the period of adoption, and new goodwill recognized in annual periods beginning after December 15, 2014 and interim periods within annual periods beginning after December 15, 2015 unless early adopted.

**Main Provisions:** If elected, a private company will amortize goodwill for ten years, or a shorter period if management demonstrates that the shorter period is more appropriate in the circumstances. A private company is not required to justify a ten year life, which the FASB acknowledged is arbitrary. In addition to goodwill arising from a business combination under Topic 805, a private company making the election is required to amortize goodwill arising from fresh-start accounting under Topic 852. The same is true of equity method goodwill arising under Topic 323.

Goodwill should be amortized on a straight-line basis. A private company may revise its useful life if warranted by changing events and circumstances, subject to the ten year limit. The balance of goodwill should be amortized over the revised useful life on a prospective basis; there is no cumulative adjustment as if goodwill had always been amortized over the revised useful life.

Private companies that elect ASU 2014-02 will be required to test goodwill for impairment when a triggering event occurs. There is no requirement to test for impairment on an annual basis. Specifically, an impairment test is required whenever an event occurs or circumstances change that indicate the fair value of the entity (or reporting unit) may be below its carrying amount, including goodwill.

When a triggering event occurs, a private company has an option to first perform a qualitative assessment to determine whether it is more likely than not (i.e., >50% likely) that the fair value of the entity or reporting unit is less than its carrying amount. If a private company elects to use the qualitative option, it must decide whether it is more than 50% likely that the fair value of the entity or reporting unit is less than its carrying amount. If so, the one-step impairment test described in the next paragraph is required. But if management concludes that fair value exceeds the carrying amount, further testing is unnecessary. For additional guidance on the qualitative assessment, refer to our [2011 Financial Reporting Newsletter](#).

Goodwill impairment is calculated as the amount by which the carrying amount of the entity (or reporting unit) including goodwill exceeds its fair value. While this guidance applies to goodwill recognized in connection with a business combination or the application of fresh-start accounting, it does not apply to equity method goodwill. Equity method investments will continue to be reviewed for impairment under Topic 323.

Impairment losses should be allocated to individual amortizable units of goodwill of the entity or reporting unit. An amortizable unit is established each time a private company recognizes new goodwill, such as through a business combination or in connection with fresh-start accounting. The allocation should be performed on a pro rata basis using the relative carrying amounts of the amortizable units or using another reasonable and rational basis. For example, the impairment may be clearly associated with a specific acquisition and related goodwill. The adjusted amount of goodwill should be amortized over the remaining useful life. A goodwill impairment loss cannot be subsequently reversed.

When a private company has a disposal transaction, a portion of goodwill must be included in the carrying amount of the net assets used to determine the gain or loss if the disposed portion of the entity (or reporting unit) meets the definition of a business under Topic 805. The entity should use a reasonable and rational approach to determine the amount of goodwill allocated to the disposal.

**► BDO COMMENT:**

One acceptable approach to determine the allocable portion of goodwill would be based on the relative fair values of the business to be disposed of and the portion of the entity (or reporting unit) that will be retained, consistent with the guidance for public entities in 350-20-40-3. Another acceptable approach would be based on the relative carrying amounts of the business to be disposed of compared to the portion of the entity retained.

**Presentation and Disclosure:** ASU 2014-02 requires private companies to separately disclose the net amount of goodwill (i.e., goodwill and accumulated amortization) as a separate line item in the balance sheet. Amortization and impairment losses must be presented within continuing operations, unless they are associated with a discontinued operation. In that case, they are included on a net-of-tax basis within discontinued operations.

- a. The ASU also requires several new disclosures:
- b. The amount of goodwill in total and by major business combination or fresh-start reorganization
- c. The weighted average amortization period in total and by major business combination or fresh-start reorganization
- d. The gross amount of goodwill, accumulated amortization and accumulated impairment losses
- e. The aggregate amortization for the period
- f. Goodwill included in a disposal group classified as held for sale and goodwill derecognized during the period without having previously been reported in a held for sale disposal group
- g. Information related to goodwill impairments and the affected financial statement line items.

The existing disclosures in Topic 350 would continue to apply, except for those related to Step Two of the current impairment test in U.S. GAAP.

**Transition:** If elected, goodwill that exists upon adoption should be amortized prospectively over 10 years, or less than 10 years if the entity demonstrates that a shorter useful life is more appropriate. Early adoption is permitted for any annual or interim period for which an entity's financial statements have not yet been made available for issuance. Upon adoption, a private company is required to make an accounting policy election as to whether goodwill will be tested for impairment at the entity level or the reporting unit level when a triggering event occurs. The FASB concluded that some entities may find it more cost-effective to test for impairment at the reporting unit level. The decision to test at the entity level or the reporting unit level is an accounting policy election that must be made upon adoption.

## ► ACCOUNTING FOR CERTAIN RECEIVE-VARIABLE, PAY-FIXED INTEREST RATE SWAPS—SIMPLIFIED HEDGE ACCOUNTING APPROACH, A CONSENSUS OF THE PCC (ASU 2014-03)

If elected, private companies will be entitled to assume no ineffectiveness in a qualifying receive-variable, pay-fixed interest rate swap (swap) that is designated in a cash flow hedging relationship when certain specified criteria are met. That is, detailed hedge effectiveness testing would not be required. In addition, the hedge documentation may be prepared any time prior to issuing the annual financial statements, instead of contemporaneously at hedge inception. Private companies also may record the swap on the balance sheet at its settlement value, which excludes nonperformance risk, rather than fair value. The simplified hedge accounting results in presenting interest expense in the income statement as if the entity had directly entered into a fixed-rate borrowing, instead of a variable-rate borrowing and a swap. The ASU is available [here](#).

**Scope and Effective Date:** The simplified hedge accounting approach can be applied by entities other than PBEs, not-for-profit entities, employee benefit plans, and financial institutions. As described in paragraph 942-320-50-1, the term financial institutions includes banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities.

The ASU is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early adoption is permitted.

**Main Provisions:** Topic 815 requires that an entity recognize all of its derivative instruments, including swaps, in its balance sheet as either assets or liabilities and measure them at fair value. To mitigate the income statement volatility of recording a swap at fair value, an entity may elect hedge accounting if certain requirements are met. Some private company stakeholders contend that many private companies find it cost-prohibitive to comply with the current requirements to qualify for hedge accounting. To mitigate such concerns, the ASU provides private companies a practical expedient to apply a simplified cash flow hedge accounting approach to account for certain swaps that are entered into for the purpose of economically converting variable-rate interest payments into fixed-rate payments.

Paragraph 815-20-25-131D of the ASU provides that no ineffectiveness may be assumed for swaps designated in a cash flow hedging relationship provided all of the following criteria are met:

- a. Both the variable rate on the swap and the borrowing are based on the same index and reset period (for example, both the swap and borrowing are based on one-month London Interbank Offered Rate [LIBOR] or both the swap and borrowing are based on three-month LIBOR). In complying with this condition, an entity is not limited to benchmark interest rates described in paragraph 815-20-25-6A.
- b. The terms of the swap are typical (in other words, the swap is what is generally considered to be a "plain-vanilla" swap), and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a comparable floor or cap.
- c. The repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days.
- d. The swap's fair value at inception (that is, at the time the derivative was executed to hedge the interest rate risk of the borrowing) is at or near zero.
- e. The notional amount of the swap matches the principal amount of the borrowing being hedged. In complying with this condition, the amount of the borrowing being hedged may be less than the total principal amount of the borrowing.
- f. All interest payments occurring on the borrowing during the term of the swap (or the effective term of the swap underlying a forward starting swap) are designated as hedged whether in total or in proportion to the principal amount of the borrowing being hedged.

To address cost and complexity concerns regarding measurement of the swap, the simplified hedge accounting approach provides private companies an option to measure the designated swap at its settlement value (i.e., primarily excluding nonperformance risk<sup>5</sup>), instead of fair value. The ASU indicates that one approach for estimating the swap's settlement value is to perform a present value calculation of the swap's remaining estimated cash flows using a valuation technique that is not adjusted for nonperformance risk.

Further, documentation required by paragraph 815-20-25-3 to qualify for hedge accounting may be completed by the date on which the first annual financial statements are available to be issued after hedge inception rather than contemporaneously at hedge inception. All other requirements in Topic 815 for cash flow hedge accounting continue to apply for the simplified hedge accounting approach.

<sup>5</sup> The risk that an entity will not fulfill an obligation. Nonperformance risk includes, but may not be limited to, the reporting entity's own credit risk.

**► BDO COMMENT:**

For example, assume a private company with a calendar fiscal year end elects the simplified hedge accounting approach and applies it to a qualifying interest rate swap entered into on January 1, 2013. The hedge could be formally documented at any point prior to the annual financial statements being issued in 2014.

If any of the conditions in paragraph 815-20-25-131D for applying the simplified hedge accounting approach subsequently cease to be met or the relationship otherwise ceases to qualify for hedge accounting, the ASU specifies that the General Subsections of Topic 815 would apply at the date of change on a prospective basis.

**Disclosure:** The ASU clarifies that the current disclosure requirements in Topic 815 and Topic 820 continue to apply for a swap accounted for under the simplified hedge accounting approach. However, in providing those disclosures, amounts recorded at settlement value may be used in place of fair value wherever applicable. Amounts disclosed at settlement value will be subject to all of the same disclosure requirements as amounts disclosed at fair value. Further, any amounts disclosed at settlement value should be clearly stated as such and disclosed separately from amounts disclosed at fair value.

The ASU also states that for the purpose of evaluating whether Topic 825 disclosures about the fair value of financial instruments are required, a swap recorded under the simplified hedge accounting approach is not considered a derivative instrument under Topic 815.<sup>6</sup>

**Transition:** An entity can elect to adopt the amendments in the ASU using either a modified retrospective transition method or a full retrospective method. Upon adoption, the modified retrospective transition method will result in a cumulative-effect adjustment to the assets, liabilities, and opening balance of accumulated other comprehensive income and retained earnings (or other appropriate components of equity) of the *current* period presented to reflect application of hedge accounting from the date the swap was entered into (or acquired) by the entity.

The full retrospective method will result in adjustments to the assets, liabilities, and opening balance of accumulated other comprehensive income and retained earnings (or other appropriate components of equity) of the *earliest* applicable period presented and thereafter to reflect the period-specific effects of applying hedge accounting from the date the receive-variable, pay-fixed interest rate swap was entered into (or acquired) by the entity.

**► ON THE HORIZON**

The FASB will consider potential changes related to goodwill and hedge accounting for public entities and not-for-profit entities in the future. It recently added a goodwill project to its agenda to explore four different alternatives, which are i) expanding the PCC alternative to other companies, ii) amortizing goodwill over its useful life not to exceed a maximum number of years, iii) a direct write-off of goodwill, and iv) simplifying the impairment test. No timeline has been set for completing this project.

The Board has agreed to evaluate improvements, including possible simplifications, to hedge accounting as a part of its larger project on financial instruments, which has been separated into three phases. The first two phases on classification & measurement and impairment are tentatively scheduled to be completed during the first half of 2014, although this date may change. No target date has been established for changes to the current hedge accounting model in U.S. GAAP.

In addition, this quarter the PCC is scheduled to discuss another approach to hedge accounting, known as the "combined instruments approach" in accounting for a subset of the swaps under the simplified hedge accounting, whose terms substantially match those of the corresponding variable rate borrowing. The combined instruments approach proposes providing private companies with an entity-wide accounting policy election to apply a scope exception from the current guidance in Topic 815 such that the swap and the borrowing are accounted for as one combined financial instrument. Similar to synthetic accounting, the swap would not be recorded in the entity's financial statements, except for the period-end accrual relating to the next swap settlement.

BDO has scheduled a webcast on February 6, 2014 to address PCC matters. It will include topics discussed in this financial reporting newsletter and other PCC developments, including possible changes to the VIE consolidation guidance that frequently applies in related party leasing arrangements. Registration is available [here](#).

## Appendix A

# FREQUENTLY ASKED QUESTIONS: ASU 2014-02, ACCOUNTING FOR GOODWILL, A CONSENSUS OF THE PCC

**Q1: Can a private company early adopt the alternative accounting method for goodwill for the year ended December 31, 2013? What about an earlier interim period, such as June 30 or September 30, 2013?**

**A1:** Yes. Early adoption is permitted so long as the private company has not previously made its interim or annual financial statements available for issuance. For calendar year-end 2013, a private company's effective date would be January 1, 2013. It would amortize all existing goodwill on a prospective basis over a ten year life, or shorter period if considered appropriate in the circumstances. There is no cumulative effect of adoption with respect to goodwill. For example, if the balance of goodwill on January 1, 2013 is \$100 and it is amortized over a ten year life, \$10 of amortization would be recognized in the 2013 income statement. Further, the date(s) at which existing goodwill was recorded in prior periods is not relevant.

**Q2: Does ASU 2014-02 specifically address the goodwill recorded as a result of pushdown accounting?**

**A2:** No. While not specifically addressed in the ASU, we believe a private company that elects the accounting alternative in ASU 2014-02 would apply it to goodwill recorded as a result of pushdown accounting because a company can only have one accounting policy for goodwill. As such, it would be inappropriate for an entity that applied pushdown accounting in 20X3 and acquired another entity in 20X4 to amortize goodwill related to the 2014 transaction without also amortizing the goodwill arising in 2013.

**Q3: What factors might cause a private company to determine the appropriate useful life of goodwill is less than ten years?**

**A3:** It depends. If management considers using a life shorter than ten years (which is not required), it should evaluate the expected timing and pattern of future cash flows that are anticipated as a result of the acquisition. For example, if a private company entered into a business combination solely for the purpose of obtaining access to the proprietary technology of the acquired entity, it may be appropriate to amortize the goodwill over the life of the proprietary technology. In addition, management and its auditor may also consider factors in connection with the business combination, such as those used in negotiations to establish a purchase price as well as the inputs and assumptions used to establish the initial fair value of the acquired assets and liabilities.

**Q4: If a private company elects the goodwill accounting alternative, is an impairment test required upon adoption?**

**A4:** No. ASU 2014-02 does not require an impairment test upon adoption. However, it requires private companies to perform an impairment test if and when events or circumstances indicate the fair value of the entity (or the reporting unit) may be below its carrying amount during the period. Any information gathered during the most recently completed impairment test prior to adoption may be useful in assessing whether a triggering event has occurred in the period of adoption.

**Q5: If the carrying amount of the private company (or reporting unit) is negative when an impairment test is performed, can an impairment loss still result?**

**A5:** Generally, no. ASU 2014-02 states "A goodwill impairment loss, if any, shall be measured as the amount by which the carrying amount of an entity (or a reporting unit) including goodwill exceeds its fair value."<sup>7</sup> Typically, the fair value of a company (or a reporting unit) is positive, i.e., at least \$1. By definition, a negative carrying amount does not exceed a positive fair value. Therefore, an impairment loss cannot be recognized despite other environmental factors that may raise concerns about recoverability. However, concerns about the recoverability of goodwill are partially mitigated through the requirement to amortize goodwill over a period not to exceed ten years. We have confirmed our understanding of this matter through informal conversations with the FASB staff.

ASU 2014-02 also states that an entity should continue to follow the applicable requirements in Topic 350 for other accounting and reporting matters related to goodwill that it does not address.<sup>8</sup> Neither ASU 2014-02, nor Topic 350, specifies how to determine the carrying amount of the entity or reporting unit. Further, in ASU 2010-28,<sup>9</sup> the FASB and EITF addressed similar concerns without mandating an approach for calculating the carrying amount of a reporting unit for purposes of Step 1 of the goodwill impairment test, even for entities with single reporting units. The EITF observed that the manner in which the fair value and carrying amount of the reporting unit is determined should be consistent. As such, many entities may continue to determine the carrying amount using an equity premise, while others may use an enterprise premise.

However, the timing of a discretionary adjustment such as a large dividend that reduces the carrying value of an entity (or reporting unit) at or near the date of an impairment test should be evaluated to determine whether it is designed to achieve a particular accounting outcome under ASU 2014-02. For example, a dividend that results in a negative equity balance followed by a subsequent capital contribution after the impairment test would generally be disregarded.

**Q6: *In the period that a goodwill impairment is recorded, is a private company required to reassess the useful life of goodwill for purposes of future amortization?***

**A6:** No. A private company may reassess the useful life of remaining goodwill, but is not required to do so, because a ten year life is always acceptable.

**Q7: *If there are indications of goodwill impairment, may a private company voluntarily apply "Step 2" of the impairment test for public companies to determine the amount of impairment under ASU 2014-02?***

**A7:** No. ASU 2014-02 does not contemplate or permit the application of a hypothetical purchase price allocation within the simplified one-step goodwill impairment test.

**Q8: *Are a private company's deferred taxes impacted by ASU 2014-02?***

**A8:** Yes, potentially. Prior to ASU 2014-02, companies with tax-deductible goodwill may have recorded a deferred tax liability for the book/tax difference associated with goodwill. The deferred tax liability was not typically considered an available source of income for the realization of other deferred tax assets because the timing of a goodwill disposal through a sale or impairment was unknown, resulting in a "naked credit" under Topic 740. However, entities electing to amortize goodwill will now be able to consider the deferred tax liability as an available source of income upon adoption. In the year of adoption, the effect of incorporating the "naked credit" into the assessment of the valuation allowance would be considered an indirect change in accounting principle under paragraph 250-10-45-8 that is recorded in earnings as an element of income tax expense (benefit).

In periods subsequent to adoption, the recognition of new tax-deductible goodwill is not expected to generate a deferred tax liability. This is because goodwill is typically amortized over 15 years for income tax purposes, which will exceed the useful life for book purposes, resulting in a deferred tax asset.

If the goodwill recorded was from a non-taxable transaction (e.g., certain business combinations), the non-deductibility of the goodwill amortization will create a permanent difference increasing the income tax expense/effective tax rate.

**Q9: *Are any transition disclosures required in the year of adoption?***

**A9:** No. While ASU 2014-02 does not require specific incremental disclosures upon adoption, we believe a private company should provide the standard disclosures in paragraphs 250-10-50-1 through 50-3 regarding the effects of adopting a new accounting principle.

<sup>8</sup> Paragraph 350-20-05-6

<sup>9</sup> When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts. See paragraph BC4.

**Q10: Does a private company need to establish preferability to initially adopt a PCC alternative?**

**A10:** No. The FASB intends PCC alternatives to be entirely elective. Upon adoption of ASU 2014-02 or the first time a private company accounts for goodwill (e.g., goodwill is recorded for the first time in connection with a business combination that closes in 2017), it is not necessary to evaluate whether one or more alternatives is considered preferable.

However, if a private company desires to change its initial election in a subsequent period, the change would only be permitted if it is considered preferable under Topic 250.

**Q11: If a private company has to unwind PCC alternatives because the company meets the definition of a PBE due to a change in circumstances, would this be considered a change in accounting principle for which preferability must be established under Topic 250?**

**A11:** No. Preferability relates to *voluntary* changes in accounting principles. A previously private company that meets the definition of a PBE for the first time due to a change in circumstances would be *required* to retrospectively apply U.S. GAAP for public companies in all prior periods.

**Q12: If a private company adopts ASU 2014-02 regarding goodwill, is it also required to adopt ASU 2014-03 regarding hedge accounting? What about future PCC alternatives?**

**A12:** No. The adoption of ASUs 2014-02 and 2014-03 are not related; that is, each can be adopted independent of the other. However, the FASB has indicated it may "link" the adoption of future PCC alternatives, if it determines such linkage is appropriate in the circumstances. Therefore, private companies will need to review future standards for this potential requirement.

**Q13: Will ASU 2014-02 affect the auditor's report?**

**A13:** It depends. In accordance with AU-C, section 708, *Consistency of Financial Statements*, the auditor of a private company electing one or more PCC alternatives evaluates the effect of the new alternative(s) on the financial statements. When a conclusion is reached that the impact is material, the auditor's report should be modified to include an emphasis-of-matter paragraph that describes the change in accounting principle(s) and provides a reference to the entity's disclosure. In accordance with AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*, the emphasis-of-matter paragraph follows immediately after the opinion paragraph. The emphasis-of-matter paragraph would be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented.

Emphasis of a Matter

As discussed in Note X to the [consolidated] financial statements, the Company has changed its method of accounting for goodwill in [year(s) of financial statements that reflect the accounting change] due to the adoption of ASU 2014-02, *Accounting for Goodwill*, a consensus of the Private Company Council. Our opinion is not modified with respect to this matter.

**Q14: If a private company's bank covenants require financial statements prepared in accordance with U.S. GAAP, do the PCC alternatives still qualify?**

**A14:** Yes. PCC alternatives, including ASU 2014-02, are included in the FASB Accounting Standards Codification. As such, they are included in U.S. GAAP, which is distinct from other comprehensive bases of accounting, such as the income tax basis.

## Appendix B

# FREQUENTLY ASKED QUESTIONS: ASU 2014-03, ACCOUNTING FOR CERTAIN RECEIVE-VARIABLE, PAY-FIXED INTEREST RATE SWAPS—SIMPLIFIED HEDGE ACCOUNTING APPROACH, A CONSENSUS OF THE PCC

**Q1:** *Can a private company early adopt the simplified hedge accounting approach for the year ended December 31, 2013? What about an earlier interim period, such as June 30 or September 30, 2013?*

**A1:** Yes, early adoption is permitted so long as the private company has not previously made its interim or annual financial statements available for issuance.

**Q2:** *Can the simplified hedge accounting approach be elected on a swap-by-swap basis?*

**A2:** Yes. Topic 815 permits election of hedge accounting on a swap-by-swap basis. As such, an entity may elect hedge accounting (and the simplified hedge accounting approach) for any, and not all, qualifying swaps.

**Q3:** *Can the simplified hedge accounting approach be used for swaps existing at the date of adoption?*

**A3:** Yes, the simplified hedge accounting approach may be elected for any qualifying swap, whether existing at the date of adoption or entered into after that date. The ASU specifies that the election to apply the simplified hedge accounting approach to an existing swap should be made upon adoption of the amendments in the Update. Similar to new swaps, the documentation required by paragraph 815-20-25-3 to qualify for hedge accounting may be completed in the period of adoption up to the date on which the first annual financial statements are available to be issued.

Further, in determining whether an existing swap meets all of the conditions in 815-20-25-131D to qualify for applying the simplified hedge accounting approach, the condition that the swap's fair value at the time of application of this approach is at or near zero need not be considered. Instead, as long as the existing swap's fair value was at or near zero at the time the swap was entered into (or acquired) by the entity, the entity may apply the simplified hedge accounting approach.

**Q4:** *Does ASU 2014-03 require a private company to formally document the hedge contemporaneously with the inception of the hedge?*

**A4:** No. Documentation required by paragraph 815-20-25-3 to qualify for hedge accounting may be completed by the date on which the first annual financial statements are available to be issued rather than contemporaneously at hedge inception. For example, assume a private company with a calendar fiscal year end elects the simplified hedge accounting approach and applies it to a qualifying interest rate swap entered into on January 1, 2013. The hedge could be formally documented at any point prior to the annual financial statements being issued in 2014.

However, private companies may wish to consider completing the documentation contemporaneously with the inception of the hedge and sharing a draft of it with the auditors before entering into the hedge. This is because if the documentation is completed subsequent to the inception of the hedge (e.g., completed in 2014 in the example above) and at that time, it is found that the simplified hedge accounting approach cannot be applied (e.g., because the repricing and settlement dates for the swap and the borrowing differ by more than a few days), the company will not be permitted to apply another method of hedge accounting retrospectively. Topic 815 requires the designation and documentation to be contemporaneous with the inception of the hedge when applying any other approach to assess hedge effectiveness.

**Q5: Can an entity measure the swap at fair value (instead of settlement value) and still apply the simplified hedge accounting approach?**

**A5:** Yes, use of settlement value as a practical alternative to fair value is an election and not a requirement for applying the simplified hedge accounting approach.

**Q6: Does ASU 2014-03 formally define "plain-vanilla" swap, as that term is used in ASC 815-20-25-131D?**

**A6:** No. A "plain-vanilla" swap is generally considered to mean a swap for which the terms and conditions are typical. However, it is not a defined term and may require the application of judgment, particularly when there are "bells and whistles" associated with the swap.

**Q7: Is application of the simplified hedge accounting approach permitted for a "forward-starting" swap?**

**A7:** Yes, the ASU provides that a cash flow hedge established through the use of a forward starting swap may be permitted in applying the simplified hedge accounting approach if the occurrence of forecasted interest payments to be swapped is probable and the other qualifying conditions are met. For a forward-starting swap, only the effective term of the swap (that is, from its effective date through its expiration date) should be considered in complying with the condition in paragraph 815-20-25-131D(f).

A forward-starting interest rate swap generally takes the form of a "plain-vanilla" swap entered into at the current date, but with a deferred effective date. Forward-starting swaps typically hedge expected debt issuances or a later deferred period, and not the initial period of an existing debt (for example, years four through six of a six-year debt for a swap entered into at the beginning of year one). Use of forward starting swaps may introduce additional complexity, particularly when attempting to hedge expected debt issuances.

**Q8: Will ASU 2014-03 affect the auditor's report for existing swaps?**

**A8:** It depends. In accordance with AU-C, section 708, *Consistency of Financial Statements*, the auditor of a private company electing one or more PCC alternatives evaluates the effect of the new alternative(s) on the financial statements. When a conclusion is reached that the impact is material, the auditor's report should be modified to include an emphasis-of-matter paragraph that describes the change in accounting principle(s) and provides a reference to the entity's disclosure. In accordance with AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*, the emphasis-of-matter paragraph follows immediately after the opinion paragraph. The emphasis-of-matter paragraph would be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is included only in the year of the change.

Emphasis of a Matter

As discussed in Note X to the [consolidated] financial statements, the Company has changed its method of accounting for certain existing interest rate swaps in [year(s) of financial statements that reflect the accounting change] due to the adoption of ASU 2014-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach*, a consensus of the Private Company Council. Our opinion is not modified with respect to this matter.

**Q9: If a private company adopts ASU 2014-03 regarding hedge accounting, is it also required to adopt ASU 2014-02 regarding goodwill? What about future PCC alternatives?**

**A9:** No. The adoption of ASUs 2014-02 and 2014-03 are not related; that is, each can be adopted independent of the other. However, the FASB has indicated it may "link" the adoption of future PCC alternatives, if it determines such linkage is appropriate in the circumstances. Therefore, private companies will need to review future standards for this potential requirement.

**Q10:** *If a private company has to unwind PCC alternatives because the company meets the definition of a PBE due to a change in circumstances, would this be considered a change in accounting principle for which preferability must be established under Topic 250?*

**A10:** No. Preferability relates to *voluntary* changes in accounting principles. A previously private company that meets the definition of a PBE for the first time due to a change in circumstances would be *required* to retrospectively apply U.S. GAAP for public companies in all prior periods.

**Q11:** *If a private company's bank covenants require financial statements prepared in accordance with U.S. GAAP, do the PCC alternatives still qualify?*

**A11:** Yes. PCC alternatives, including ASU 2014-03, are included in the FASB Accounting Standards Codification. As such, they are included in U.S. GAAP, which is distinct from other comprehensive bases of accounting, such as the income tax basis.

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## ► CONTACT:

If you would like further information or to discuss the implications of the matters discussed in this newsletter, please contact the BDO engagement partner serving you or one of the following partners:

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**ADAM BROWN**  
National Assurance Partner  
214-665-0673 / [abrown@bdo.com](mailto:abrown@bdo.com)

---

**GAUTAM GOSWAMI**  
National Assurance Partner  
312-616-4631 / [ggoswami@bdo.com](mailto:ggoswami@bdo.com)

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**CHRIS SMITH**  
Audit & Accounting Professional Practice Leader  
310-557-8549 / [chsmith@bdo.com](mailto:chsmith@bdo.com)