FASB In Focus

Updates for Private Companies on Accounting for Goodwill, Interest Rate Swaps

Overview

The Financial Accounting Standards Board (FASB) on January 16, 2014 issued two updates to U.S. Generally Accepted Accounting Principles (GAAP) that provide alternatives for private companies. The first relates to accounting for goodwill. The second involves interest rate swaps—specifically introducing a simplified hedge accounting approach for certain types of swaps. Both updates are consensuses of the Private Company Council (PCC) that were endorsed by the FASB.

FASB Accounting Standards Update No. 2014-02, *Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill*, permits a private company to subsequently amortize goodwill on a straight-line basis over a period of ten years, or less if the company demonstrates that another useful life is more appropriate. It also permits a private company to apply a simplified impairment model to goodwill. Goodwill is the residual asset recognized in a business combination after re-cognizing all other identifiable assets acquired and liabilities assumed.

FASB Accounting Standards Update No. 2014-03, *Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach*, gives private companies—other than financial institutions, the option to use a simplified hedge accounting approach to account for swaps that are entered into for the purpose of economically converting variable-rate interest payments into fixed-rate payments.

The simplified hedge accounting results in presenting interest expense in the income statement as if the company had issued a fixed-rate borrowing, instead of a variable-rate borrowing and an interest rate swap.

Accounting for Goodwill

The accounting standard on goodwill would permit private companies to amortize goodwill and also apply a simplified goodwill impairment model.

During its outreach to users of private company financial statements, the PCC learned that the current accounting for goodwill impairment provides limited benefits to users because users often disregard goodwill and goodwill impairment losses in their analysis of a private company's financial condition and operating performance. Preparers and public accountants also told the PCC that they are concerned with the cost and complexity of the current goodwill impairment test.

Current U.S. GAAP requires goodwill of a reporting unit to be tested for impairment at least annually—or more frequently if certain conditions exist. Also under current U.S. GAAP:

- A company can choose first to perform a qualitative assessment to determine whether it is more likely than not that a reporting unit's fair value is less than its carrying amount, or it can bypass the qualitative assessment and proceed directly to step one and compare the carrying amount of the reporting unit with its fair value.
- If its carrying amount exceeds its fair value, step two must be performed to determine the extent of goodwill impairment, if any.
- Step two compares the implied fair value of the reporting unit's goodwill with its carrying amount which necessitates performing a hypothetical application of the acquisition method to determine the implied fair value of goodwill after measuring the reporting unit's identifiable assets and liabilities in accordance with Topic 805, Business Combinations.

This Update allows a private company to use an accounting alternative to subsequently measure goodwill. A private company that elects the accounting alternative should amortize goodwill on a straight-line basis over 10 years, or less than 10 years if the company demonstrates that another useful life is more appropriate.

A company that elects this accounting alternative is required to make an accounting policy decision to test goodwill for impairment at either the company level or the reporting unit level. Goodwill should be tested for impairment when a triggering event occurs that indicates that the fair value of an entity (or a reporting unit) may be below its carrying amount. Additionally, step two of the current impairment test was eliminated.

The combination of the amortization method and the relief from the requirement to test goodwill for impairment at least annually is expected to result in significant cost savings for many private companies that carry goodwill on their balance sheets.

The accounting alternative for goodwill is intended to reduce the cost and complexity for preparers without a loss of relevant information for users of private company financial statements.

This is because amortization should reduce the likelihood of impairments, and private companies generally will test goodwill for impairment less frequently. In addition, when impairment tests are required, the elimination of step two and the ability to test for impairment at the company-level should significantly reduce the cost of the impairment test.

The FASB also recently decided to add a project to its agenda to consider the issue on the subsequent accounting for goodwill for public companies and not-for-profit organizations.

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

The accounting alternative on interest rate swaps gives private companies the option to apply a simplified hedge accounting approach to account for certain types of interest rate swaps that are entered into for the purpose of economically converting variable-rate interest payments to fixed-rate payments. The alternative also extends the exemption from certain fair value disclosures to private companies for which such swaps are their only derivatives.

The PCC received input through outreach that private companies often find it difficult to obtain fixed-rate borrowing. In order to do so, some private companies enter into an interest rate swap (a derivative instrument) to economically convert their variable-rate borrowing to a fixed-rate borrowing.

Current U.S. GAAP Topic 815, Derivatives and Hedging, requires that a company recognize all of its derivative instruments 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, a company may elect hedge accounting if certain requirements are met.

Some private company stakeholders contend that because of limited resources and/or the difficulty of understanding and applying hedge accounting, many private companies lack the expertise to comply with the requirements to qualify for hedge accounting. Therefore, they do not elect to apply hedge accounting, which results in income statement volatility because changes in the fair value of their derivative instrument are recognized in earnings.

In addition, some stakeholders question the relevance and cost associated with determining and presenting the fair value of a swap that is entered into for the purposes of economically converting a variable-rate borrowing to a fixed-rate borrowing.

The accounting alternative for interest rate swaps:

- **provides private companies a practical expedient to apply a more simplified cash flow hedge accounting approach to account for interest rate swaps in a less costly and complex manner,**
- **reduces private companies' income statement volatility while still providing relevant information for lenders and investors.**

Under the accounting alternative provided for interest rate swaps, when a private company applies the simplified hedge accounting approach, the income statement charge for interest expense will be similar to the amount that would result if the company had

directly entered into a fixed-rate borrowing instead of a variable-rate borrowing and an interest rate swap.

Furthermore, the simplified hedge accounting approach allows the swap to be measured at its settlement value instead of fair value. Because settlement value is generally easier to determine in comparison to fair value, this will alleviate some of the cost and complexity concerns that have been raised by some private company stakeholders with regard to estimating fair value.

The FASB decided to not extend this alternative to public companies and not-for-profit organizations at this time, but will consider the accounting for such swaps as part of the Board's broader hedge accounting project.

The GAAP alternative on interest rate swaps represented a change from the original proposal. The original proposal provided private companies the option to use a simplified hedge accounting approach and a combined instruments approach to account for certain types of interest rate swaps.

The PCC decided to separate the combined instruments approach from the original proposal and directed the FASB staff to conduct more research on the combined instruments approach for further discussion at the January 28, 2014 meeting. The combined instruments approach would be for a subset of the swaps under the simplified hedge accounting, whose terms substantially match those of the corresponding variable rate loan.

When Would the Accounting Alternatives Be Effective?

Both alternatives will be effective for annual periods beginning after December 15, 2014, and interim periods beginning after December 15, 2015.

Early application is permitted for both alternatives.■

For more information on the project, including the standards, press release and video, please visit the FASB website at www.fasb.org or the PCC website at www.fasb.org/pcc.

The views expressed in this document do not necessarily reflect the views of the FASB. Official positions of the FASB are arrived at only after extensive due process and deliberation.

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