MARKS PANETH

ACCOUNTANTS & ADVISORS

MARKS PANETH ACCOUNTING AND AUDITING ALERT: FASB PROVIDES ALTERNATIVES FOR PRIVATE COMPANIES ON ACCOUNTING FOR GOODWILL, INTEREST RATE SWAPS

The Financial Accounting Standards Board (FASB) has issued two updates to Generally Accepted Accounting Principles (GAAP) that are intended to reduce the cost and complexity of preparing financial statements for private companies. As outlined in Accounting Standards Update (ASU) 2014-02, *Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill*, and ASU 2014-03, *Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach,* the alternative standards streamline the method for goodwill impairment and make it easier for certain interest rate swaps to qualify for hedge accounting.

MOVE TOWARD PRIVATE COMPANY ALTERNATIVES TO GAAP

The updates grew out of proposals from the Private Company Council (PCC) and were endorsed by FASB last year. The Financial Accounting Foundation, FASB's parent organization, formed the PCC in May 2012 to improve the process of setting accounting standards for private companies that need or are required to have financial statements prepared in accordance with GAAP.

In December 2013, FASB and the PCC released new guidance, *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies* (the Guide), to be used to determine whether private companies should be allowed to use alternative standards in the areas of recognition and measurement, disclosures, display/presentation, effective date and transition method. For each of these areas, the Guide describes criteria FASB and the PCC will use to evaluate whether to permit alternative guidance. ASU 2014-02 and ASU 2014-03 contain the first of the alternative guidance.

EXISTING GAAP FOR GOODWILL

The term "goodwill" refers to the residual asset recognized in a business combination, such as a merger, after recognizing all other identifiable assets acquired and liabilities assumed. Under GAAP, goodwill is carried on the books at its initial value less any impairment. It isn't subject to amortization.

Goodwill is considered impaired when the implied fair value of goodwill in a company's reporting unit — basically, an operating unit that has its own discrete financial information, separate from the overall company — falls to an amount that's less than its carrying amount, or book value, including any deferred income taxes. Under GAAP, companies must test for impairment at least annually, and more frequently if certain conditions exist.

GAAP allows a company to choose initially to perform a *qualitative* evaluation to determine whether it's more likely than not (that is, a likelihood of more than 50%) that a reporting unit's fair value is less than its carrying amount. If the company determines it's *not* more likely than not that fair value is less than the carrying amount, it need not perform a *quantitative* two-step impairment test. If it *is* more likely than not, the company must proceed to the two-step impairment test.

In the first step, the company calculates the fair value of the reporting unit and compares that amount with the reporting unit's carrying amount, including goodwill. If the carrying amount exceeds the fair value, the company performs the second step — measuring the amount of the goodwill impairment loss, if any, by

comparing the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill. This requires 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.

PRIVATE COMPANY GOODWILL ALTERNATIVE

Preparers and auditors of private company financial statements have complained about the cost and complexity involved in carrying out the existing GAAP goodwill standards. Moreover, users of these financial statements have indicated that the requirements provide limited benefits to them because they often disregard goodwill and impairment losses when analyzing a company's financial condition and operating performance.

The alternative standards in ASU 2014-02 are designed to address these concerns. They allow a private company to amortize goodwill after its acquisition (and initial recognition and measurement) on a straight-line basis during a period of 10 years, or less if the company demonstrates that another useful life is more appropriate. The company can revise the remaining useful life of goodwill in response to events and changes in circumstances that warrant a revision, but the cumulative amortization period can't exceed 10 years.

A company that elects this alternative must make an accounting policy decision to test goodwill for impairment at either the company level or the reporting unit level. But goodwill needs to be tested for impairment only when a triggering event — such as a significant adverse change in business climate, legal issues or loss of key personnel — occurs that indicates the fair value of a company or a reporting unit may be below its carrying amount.

The alternative standard also drops the second step of the existing impairment test: the costly and complicated hypothetical application of the acquisition method. Instead, the amount of the impairment equals the amount by which the carrying amount of the company or reporting unit exceeds its fair value. The goodwill impairment loss can't exceed the company's or reporting unit's carrying amount of goodwill.

The aggregate amount of goodwill net of accumulated amortization and impairment will appear as a separate line item in the company's statement of financial position. The amortization and aggregate amount of goodwill impairment will be presented in income statement line items within continuing operations unless the amortization or impairment is associated with a discontinued operation. Such amortization and impairment must be included on a net-of-tax basis within the results of discontinued operations.

The disclosures required under this alternative are similar to existing GAAP. A company that elects the alternative, however, isn't required to present changes in goodwill in a tabular reconciliation.

BENEFITS OF THE GOODWILL ALTERNATIVE

Private companies that opt for the goodwill alternative may experience significant cost savings because of the combination of the amortization method and the elimination of the requirement to test goodwill for impairment at least annually. Amortization should reduce the likelihood of impairments, and testing may occur less frequently. When impairment testing *is* required, the removal of the second step and the ability to test at the company level (as opposed to the reporting unit level) should cut the test's cost.

Once elected, the goodwill alternative will apply prospectively. A company will amortize existing goodwill starting at the beginning of the period of adoption in which the alternative is elected, as well as new goodwill recognized after the beginning of the annual period of adoption.

INTEREST SWAP ALTERNATIVE

Private companies can find it difficult to obtain fixed-rate loans. They often must enter into an interest rate swap (a derivative instrument) to economically convert their variable-rate loans to fixed-rate loans.

Existing GAAP guidance requires a company to recognize all of its derivative instruments in its balance sheet as either assets or liabilities and measure them at fair value.

A company may elect cash flow hedge accounting to mitigate income statement volatility if certain requirements are met. But many private companies lack the resources and expertise to comply with the requirements and, therefore, remain vulnerable to volatility.

The alternative standards in ASU 2014-03 will allow nonfinancial institution private companies to apply a simplified hedge accounting approach to their receive-variable, pay-fixed interest rate swaps as long as the terms of the swap and the related debt are aligned. Using this hedge accounting results in presenting interest expense in the income statement as if the company had directly entered a fixed-rate loan, instead of a variable-rate loan and an interest rate swap. Companies applying the alternative will have until the issuance of their financial statements to complete the required hedging documentation.

The alternative standard also allows a private company to recognize the swap at its settlement value, which measures the swap without consideration of nonperformance risk, rather than at fair value. Private companies that apply this alternative may enjoy cost savings, because settlement value is generally easier to determine than fair value. The variability of the fair value or settlement amount will be recorded as accumulated other comprehensive income (part of equity).

The standard can be applied to both existing and new qualifying swaps because the election of hedge accounting can be made on a swap-by-swap basis. This is good news for private companies that chose not to elect hedge accounting in the past because of the difficulty involved in complying with the requirements.

AVAILABILITY OF THE ALTERNATIVES

Users of financial statements, including regulators, lenders or other creditors, may require a private company to continue to apply traditional GAAP accounting standards, even if the company is otherwise eligible for the alternatives. Further, FASB is working on a project that addresses the subsequent accounting for goodwill for public companies and not-for-profit organizations, which could result in a future change to the subsequent accounting for goodwill for all entities, including private companies.

And a company that elects an accounting alternative could subsequently become subject to public company reporting and, therefore, need to recast prior periods as if it hadn't elected the alternative.

EFFECTIVE DATES

Both of the new alternatives will be effective for annual periods beginning after Dec. 15, 2014, and interim periods beginning after Dec. 15, 2015. Early adoption is permitted, so an eligible private company could elect to apply the alternatives on its 2013 financial statements, as long as the financial statements weren't made available for issuance before the ASUs were released.

If you have questions regarding how the updates affect how you prepare your financial statements, please give us a call. We'd be happy to answer your questions.

FOR MORE INFORMATION

If you have questions, please contact William M. Stocker III, Partner-in-Charge of the Professional Practice Group, by phone at 212.503.8875 or by email at wstocker@markspaneth.com or any of our Marks Paneth professionals.

FINANCIAL STATEMENTS: A COMBINATION OF ART AND SCIENCE

Financial statements are supposed to depict the reality of a business' health in a way that allows a company to be compared to its competitors. However, any portrayal of a business on a few sheets of paper is inherently distorted -- like depicting a multi-dimensional reality on a two-dimensional financial

statement. In this short video, William M. Stocker III outlines the issues that both the stakeholder and the preparer need to be aware of and the important things to keep in mind about financial statements.

IRS CIRCULAR 230 DISCLOSURE

Treasury Regulations require us to inform you that any Federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.