

# FINANCIAL ACCOUNTING SERIES



No. 2014-03  
January 2014

## Derivatives and Hedging (Topic 815)

Accounting for Certain Receive-Variable,  
Pay-Fixed Interest Rate Swaps—Simplified  
Hedge Accounting Approach

a consensus of the Private Company Council

An Amendment of the *FASB Accounting Standards Codification*®

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Financial Accounting Standards Board



# Accounting Standards Update 2014-03

## Derivatives and Hedging (Topic 815)

### Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach

January 2014

## CONTENTS

	Page Numbers
Summary .....	1–5
Amendments to the <i>FASB Accounting Standards Codification</i> ® .....	7–16
Background Information and Basis for Conclusions .....	17–25



# Summary

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## Why Is the FASB Issuing This Accounting Standards Update (Update)?

The Private Company Council (PCC) received input through outreach that private companies often find it difficult to obtain fixed-rate borrowing. Therefore, some private companies enter into a receive-variable, pay-fixed interest rate swap to economically convert their variable-rate borrowing into a fixed-rate borrowing. Under U.S. generally accepted accounting principles (GAAP), a swap is a derivative instrument. Topic 815, Derivatives and Hedging, requires that an entity recognize all interest rate swaps on its balance sheet as either assets or liabilities and measure them at fair value. To mitigate the income statement volatility of recording a swap's change in fair value, Topic 815 permits an entity to elect hedge accounting if certain requirements under that Topic are met. Some private company stakeholders contend that because of limited resources and the fact that hedge accounting is difficult to understand and apply, 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. 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 purpose of economically converting a variable-rate borrowing to a fixed-rate borrowing.

The objective of the amendments in this Update is to address the concerns of private company stakeholders by providing an additional hedge accounting alternative within Topic 815 for certain types of swaps that are entered into by a private company for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing. This additional hedge accounting alternative (that is, the simplified hedge accounting approach) acts as a practical expedient to qualify for cash flow hedge accounting under Topic 815 if certain conditions are met.

## Who Is Affected by the Amendments in This Update?

The amendments in this Update apply to all entities, except for public business entities and not-for-profit entities as defined in the Master Glossary of the *FASB Accounting Standards Codification*<sup>®</sup>, employee benefit plans within the scope of Topics 960 through 965 on plan accounting, 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.

## What Are the Main Provisions?

The amendments in this Update allow the use of the simplified hedge accounting approach to account for swaps that are entered into for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing. Under this approach, the income statement charge for interest expense will be similar to the amount that would result if the entity had directly entered into a fixed-rate borrowing instead of a variable-rate borrowing and a receive-variable, pay-fixed interest rate swap. Alternatively, that entity may continue to follow the current guidance in Topic 815.

The simplified hedge accounting approach provides entities within the scope of this Update with a practical expedient to qualify for cash flow hedge accounting under Topic 815. Under this approach, an entity may assume no ineffectiveness for qualifying swaps designated in a hedging relationship under Topic 815. This approach can be applied to a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap 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 the forward starting swap) are designated as hedged whether in total or in proportion to the principal amount of the borrowing being hedged.

Under the simplified hedge accounting approach, a private company has the option to measure the designated swap at settlement value instead of fair value. The primary difference between settlement value and fair value is that



nonperformance risk is not considered in determining settlement value. One approach for estimating the receive-variable, pay-fixed interest rate 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.

Under the simplified hedge accounting approach, documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed by the date on which the first annual financial statements are available to be issued after hedge inception rather than concurrently at hedge inception. Because Topic 815 permits election of hedge accounting on a swap-by-swap basis, a private company can elect to apply this approach to any qualifying swap, whether existing at the date of adoption of this Update or entered into after that date. In determining whether an existing swap otherwise meets all of the requirements for applying this approach at adoption, the criterion that the swap's fair value at the time of the application of this approach is at or near zero does not need to be considered as long as the swap's fair value was at or near zero at the time the swap was entered into by the private company.

All other requirements in Topic 815 for cash flow hedge accounting apply for the simplified hedge accounting approach. In addition, the current disclosure requirements in Topic 815 and Topic 820 on fair value measurement continue to apply for a swap accounted for under the simplified hedge accounting approach. In providing those disclosures, amounts recorded at settlement value may be used in place of fair value wherever applicable with amounts disclosed at settlement value subject to all of the same disclosure requirements as amounts disclosed at fair value. Any amounts disclosed at settlement value should be clearly stated as such and disclosed separately from amounts disclosed at fair value.

This Update also addresses scope requirements contained in Topic 825 on financial instruments, which provides guidance on required disclosures about the fair value of financial instruments for assets and liabilities that are not measured at fair value in the statement of financial position for which it is practicable to estimate fair value. In accordance with paragraph 825-10-50-3, entities are exempt from Topic 825 fair value disclosures only if all of the following conditions are met:

- a. The entity is a nonpublic entity.
- b. The entity's total assets are less than \$100 million on the date of the financial statements.
- c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under Topic 815 other than commitments related to the origination of mortgage loans to be held for sale during the reporting period.

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.

## How Do the Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

The amendments provide entities within the scope of this Update with a practical expedient to apply cash flow hedge accounting for certain types of swaps that are entered into for the purpose of economically converting variable-rate borrowings into fixed-rate borrowings, thus addressing some private company stakeholders' concerns about the costs and complexity of applying current U.S. GAAP to swaps in those circumstances. Because the income statement charge for interest expense under the simplified hedge accounting approach is similar to the amount that would result if the entity had directly entered into a fixed-rate borrowing instead of a variable-rate borrowing and a receive-variable, pay-fixed interest rate swap, the amendments in this Update reduce income statement volatility and address private company stakeholders' concerns about the difficulty in understanding and applying the hedge accounting model in such circumstances while still providing relevant information.

The amendments in this Update allow the swap to be measured at its settlement value instead of fair value when applying the simplified hedge accounting approach. Because settlement value is generally easier to determine in comparison to fair value, the PCC concluded that 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.

Overall, the PCC concluded that the simplified hedge accounting approach is responsive to the needs of private company stakeholders. The alternative approach in this Update will continue to provide decision-useful information to the users of private company financial statements, while providing a reduction in the cost and complexity in accounting for such swaps by preparers. Therefore, the amendments meet the overall objective of the Private Company Decision-Making Framework for addressing the needs of private company stakeholders.

## When Will the Amendments Be Effective?

The simplified hedge accounting approach will be effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015, with early adoption permitted. Private companies have the option to apply the amendments in this Update using either one of the following approaches:

- a. A modified retrospective approach in which corresponding adjustments should be made 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 receive-variable, pay-fixed interest rate swap was entered into (or acquired) by the entity.
- b. A full retrospective approach in which financial statements should be adjusted 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 and corresponding adjustments should be made to the assets, liabilities, and opening balance of accumulated other comprehensive income and retained earnings (or other appropriate components of equity) of the earliest period presented to reflect application of hedge accounting from the date the receive-variable, pay-fixed interest rate swap was entered into (or acquired) by the entity.



# Amendments to the *FASB Accounting Standards Codification*<sup>®</sup>

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## Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–12. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

## Amendments to Master Glossary

2. Add the Master Glossary term *Nonperformance Risk* to Subtopic 815-10 as follows:

### **Nonperformance Risk**

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.

3. Add the following Master Glossary terms to Subtopic 815-20 as follows:

### **Financial Statements Are Available to Be Issued**

Financial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders. The process involved in creating and distributing the financial statements will vary depending on an entity's management and corporate governance structure as well as statutory and regulatory requirements.

### **Not-for-Profit Entity**

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

- a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
- b. Operating purposes other than to provide goods or services at a profit
- c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

- a. All investor-owned entities
- b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

### **Private Company**

An entity other than a **public business entity**, a **not-for-profit entity**, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.

### **Public Business Entity**

A public business entity is a business entity meeting any one of the criteria below. Neither a **not-for-profit entity** nor an employee benefit plan is a business entity.

- 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 public business entity for purposes of financial statements that are filed or furnished with the SEC.

## **Amendments to Subtopic 815-10**

4. Add paragraphs 815-10-35-1A through 35-1C, with a link to transition paragraph 815-10-65-6, as follows:

## **Derivatives and Hedging—Overall**

### **Subsequent Measurement**

**815-10-35-1** All derivative instruments shall be measured subsequently at **fair value**.

**815-10-35-1A** As a practical expedient, a receive-variable, pay-fixed interest rate swap for which the simplified hedge accounting approach (see paragraphs 815-20-25-131A through 25-131E for scope) is applied may be measured subsequently at settlement value instead of fair value.

**815-10-35-1B** The primary difference between settlement value and fair value is that **nonperformance risk** is not considered in determining settlement value. One approach for estimating the receive-variable, pay-fixed interest rate 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.

**815-10-35-1C** 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 General Subsections of this Topic shall apply at the date of change and on a prospective basis. For example, if the related variable-rate borrowing is prepaid without terminating the receive-variable, pay-fixed interest rate swap, the gain or loss on the swap in accumulated other comprehensive income shall be reclassified to earnings in accordance with paragraphs 815-30-40-1 through 40-6 with the swap measured at fair value on the date of change and subsequent changes in fair value reported in earnings in accordance with paragraph 815-10-35-2. Similarly, if the receive-variable, pay-fixed interest rate swap is terminated early without the related variable-rate borrowing being prepaid, the gain or loss on the swap in accumulated other comprehensive income shall be reclassified to earnings in accordance with paragraphs 815-30-40-1 through 40-6.

5. Add paragraph 815-10-50-3, with a link to transition on paragraph 815-10-65-6, as follows:

### **Disclosure**

**815-10-50-3** ~~Paragraph not used.~~ If the simplified hedge accounting approach (see paragraphs 815-20-25-131A through 25-131E) is applied in accounting for a qualifying receive-variable, pay-fixed interest rate swap, the settlement value of that swap may be used in place of **{add glossary link to 2<sup>nd</sup> definition} fair value {add glossary link to 2<sup>nd</sup> definition}** when disclosing the information required by this Section or in providing other fair value disclosures, such as those required under Topic 820 on fair value. For the purposes of complying with these

disclosure requirements, amounts disclosed at settlement value will be subject to all of the same disclosure requirements as amounts disclosed at fair value. Any amounts disclosed at settlement value shall be clearly stated as such and disclosed separately from amounts disclosed at fair value.

## Amendments to Subtopic 815-20

6. Amend paragraph 815-20-25-119 and add paragraphs 815-20-25-131A through 25-131E and their related heading, with a link to transition paragraph 815-10-65-6, as follows:

### **Derivatives and Hedging—Hedging—General**

#### **Recognition**

##### **> > Hedge Effectiveness Criteria Applicable to Cash Flow Hedges Only**

**815-20-25-119** The hedge effectiveness criteria applicable to cash flow hedges only are organized as follows:

- a. Consideration of the time value of money
- b. Consideration of counterparty credit risk
- c. Additional considerations for options in cash flow hedges
- d. Assuming no hedge ineffectiveness in a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap recorded under the simplified hedge accounting approach.

##### **> > > Assuming No Hedge Ineffectiveness in a Cash Flow Hedge of a Variable-Rate Borrowing with a Receive-Variable, Pay-Fixed Interest Rate Swap Recorded under the Simplified Hedge Accounting Approach**

**815-20-25-131A** The conditions for the simplified hedge accounting approach determine which cash flow hedging relationships qualify for a simplified version of hedge accounting. If all of the conditions in paragraphs 815-20-25-131B and 815-20-25-131D are met, an entity may assume that there is no ineffectiveness in a cash flow hedging relationship involving a variable-rate borrowing and a receive-variable, pay-fixed interest rate swap.

**815-20-25-131B** Provided all of the conditions in paragraph 815-20-25-131D are met, the simplified hedge accounting approach may be applied by a **private company** except for a financial institution as described in paragraph 942-320-50-1. An entity may elect the simplified hedge accounting approach for any receive-variable, pay-fixed interest rate swap, provided that all of the conditions for applying the simplified hedge accounting approach specified in paragraph 815-20-25-131D are met. Implementation guidance on the conditions set forth in paragraph 815-20-25-131D is provided in paragraphs 815-20-55-79A through 55-79B.



**815-20-25-131C** In applying the simplified hedge accounting approach, the documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed by the date on which the first annual **financial statements are available to be issued** after hedge inception rather than concurrently at hedge inception.

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

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

**815-20-25-131E** A cash flow hedge established through the use of a forward starting receive-variable, pay-fixed interest rate swap may be permitted in applying the simplified hedge accounting approach only if the occurrence of forecasted interest payments to be swapped is probable. When forecasted interest payments are no longer probable of occurring, a cash flow hedging relationship will no longer qualify for the simplified hedge accounting approach and the General Subsections of this Topic shall apply at the date of change and on a prospective basis.

7. Amend paragraph 815-20-55-54 and add paragraphs 815-20-55-79A through 55-79B and their related heading, with a link to transition paragraph 815-10-65-6, as follows:

## Implementation Guidance and Illustrations

### > > Hedge Effectiveness

**815-20-55-54** This implementation guidance on hedge effectiveness is organized as follows:

- a. Change in assessment methods
- b. Components of option time value
- c. Effect of interest rate indexes
- d. Prohibition of preset hedge coverage ratios
- e. Methodologies to assess effectiveness of fair value and cash flow hedges
- f. Applicability of the shortcut method
- g. Application of the prepayable criterion under the shortcut method
- h. Determining whether a mirror-image call provision exists in application of the shortcut method.
- i. Simplified hedge accounting approach.

### > > > Simplified Hedge Accounting Approach

**815-20-55-79A** In complying with the condition in paragraph 815-20-25-131D(b), comparable does not necessarily mean equal. For example, if the swap's variable rate is the London Interbank Offered Rate (LIBOR) and the borrowing's variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the borrowing.

**815-20-55-79B** For a forward-starting swap, only the effective term of the receive-variable, pay-fixed interest rate swap (that is, from its effective date through its expiration date) shall be considered in complying with the condition in paragraph 815-20-25-131D(f). The period from the swap's inception to the date the swap is effective shall not be considered in complying with the condition in paragraph 815-20-25-131D(f) because the effective date of a forward-starting swap occurs after the swap's inception. For example, a forward-starting receive-variable, pay-fixed, interest rate swap with a five-year effective term and an effective date commencing one year after the swap's inception would meet the condition in paragraph 815-20-25-131D(f) if designated as a hedge of a five-year, variable-rate borrowing forecasted to be entered into one year after the swap's inception.

## Amendments to Subtopic 825-10

8. Amend paragraph 825-10-50-3 and paragraph 825-10-50-8 by adding item j, with a link to transition paragraph 815-10-65-6, as follows:

### **Financial Instruments—Overall**

#### **Disclosure**

**825-10-50-3** Except as noted in the following paragraph, for annual reporting periods, the disclosure guidance related to fair value of financial instruments in paragraphs 825-10-50-10 through 50-19 applies to all entities but is optional for an entity that meets all of the following criteria:

- a. The entity is a **nonpublic entity**.
- b. The entity's total assets are less than \$100 million on the date of the financial statements.
- c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under Topic 815 other than commitments related to the origination of mortgage loans to be held for sale during the reporting period. For purposes of this disclosure guidance, a receive-variable, pay-fixed interest rate swap for which the simplified hedge accounting approach (see Subtopic 815-20) is applied shall not be considered an instrument that is accounted for as a derivative instrument under Topic 815.

#### > > Transactions

**825-10-50-8** In part, this Subsection requires disclosures about fair value for all financial instruments, whether recognized or not recognized in the statement of financial position, except that the disclosures about fair value prescribed in paragraphs 825-10-50-10 through 50-16 are not required for any of the following:

- j. Receive-variable, pay-fixed interest rate swaps for which the simplified hedge accounting approach is applied (see Topic 815).

9. Add paragraph 815-10-65-6 and its related heading as follows:

**> Transition Related to 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**

**815-10-65-6** The following represents the transition and effective date information related to 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*:

- a. The pending content that links to this paragraph shall be effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015.
- b. The pending content that links to this paragraph related to the simplified hedge accounting approach shall be applied in either of the following ways:
  1. Using a modified retrospective approach in which corresponding adjustments shall be made 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 under this Topic from the date the receive-variable, pay-fixed interest rate swap was entered into (or acquired) by the entity.

2. Using a full retrospective approach in which:

i. The financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying hedge accounting under this Topic from the date the receive-variable, pay-fixed interest rate swap was entered into (or acquired) by the entity.

ii. Corresponding adjustments shall be made to the assets, liabilities, and opening balance of accumulated other comprehensive income and retained earnings (or other appropriate components of equity) of the earliest period presented to reflect application of hedge accounting under this Topic from the date the receive-variable, pay-fixed interest rate swap was entered into (or acquired) by the entity.

c. The simplified hedge accounting approach may be elected for any qualifying receive-variable, pay-fixed interest rate swap, whether existing at the date of adoption of the pending content that links to this paragraph or entered into after that date. The election to apply the simplified hedge accounting approach to an existing swap shall be made upon adoption of the pending content that links to this paragraph. In determining whether an existing swap meets all of the conditions in paragraph 815-20-25-131D to qualify for applying the simplified hedge accounting approach, the condition that the swap's fair value at the time of application of this approach is at or near zero need not be considered. Instead, as long as the swap's fair value was at or near zero at the time the swap was entered into (or acquired) by the entity, the entity may apply the simplified hedge accounting approach. For an existing swap, the documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed in the period of adoption by the date on which the first annual **financial statements are available to be issued** rather than concurrently at hedge inception.

d. Early application of the pending content that links to this paragraph is permitted for any annual or interim period for which the entity's financial statements have not yet been made available for issuance.

e. An entity shall provide the disclosures in paragraphs 250-10-50-1 through 50-3 in the period that the entity adopts the pending content that links to this paragraph.

10. Amend paragraph 815-10-00-1, by adding the following items to the table, as follows:

**815-10-00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
<b>Financial Statements Are Available to Be Issued</b>	Added	2014-03	01/16/2014
<b>Nonperformance Risk</b>	Added	2014-03	01/16/2014
815-10-35-1A through 35-1C	Added	2014-03	01/16/2014
815-10-50-3	Added	2014-03	01/16/2014
815-10-65-6	Added	2014-03	01/16/2014

11. Amend paragraph 815-20-00-1, by adding the following items to the table, as follows:

**815-20-00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
<b>Financial Statements Are Available to Be Issued</b>	Added	2014-03	01/16/2014
<b>Not-for-Profit Entity</b>	Added	2014-03	01/16/2014
<b>Private Company</b>	Added	2014-03	01/16/2014
<b>Public Business Entity</b>	Added	2014-03	01/16/2014
815-20-25-119	Amended	2014-03	01/16/2014
815-20-25-131A through 25-131E	Added	2014-03	01/16/2014
815-20-55-54	Amended	2014-03	01/16/2014
815-20-55-79A	Added	2014-03	01/16/2014
815-20-55-79B	Added	2014-03	01/16/2014

12. Amend paragraph 825-10-00-1, by adding the following items to the table, as follows:

**825-10-00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
825-10-50-3	Amended	2014-03	01/16/2014
825-10-50-8	Amended	2014-03	01/16/2014

*The amendments in this Update were endorsed by the affirmative vote of six members of the Financial Accounting Standards Board. Mr. Smith dissented.*

Mr. Smith objects to the issuance of this Update for two fundamental reasons. Rather than proceeding to issue an accounting alternative that is only available to private companies, Mr. Smith would rather consider whether the proposal should be adopted as a simplification to the accounting for certain receive-variable, pay-fixed interest rate swap transactions for all entities. As stated in his dissent to the Private Company Decision-Making Framework, Mr. Smith questions the appropriateness of creating alternatives within U.S. GAAP, particularly when there are simplifications available that could be applied to both private entities and public entities. Mr. Smith believes this issue is faced by both public companies and private companies and he fails to see why an alternative accounting method should be available to only private companies. However, Mr. Smith would not support the issuance of a final standard in its current form. Mr. Smith believes it is inappropriate to relax the required documentation rules to the extent permitted under the amendments in this Update. Mr. Smith believes relaxing the rules allows preparers to evaluate the consequences of the hedge and select the outcome it desires in the circumstances (that is, hedge accounting or no hedge accounting). Mr. Smith believes a more effective approach would have been to critically evaluate the documentation requirements and tailor them (in other words, simplify them) to fit the circumstances of the simplified hedging model. He believes the documentation requirements could have been vastly simplified, thereby making timely documentation (which he would define as “within a few weeks” of entering into a hedging arrangement) easier for all parties.

*Members of the Financial Accounting Standards Board:*

Russell G. Golden, *Chairman*  
James L. Kroeker, *Vice Chairman*  
Daryl E. Buck  
Thomas J. Linsmeier  
R. Harold Schroeder  
Marc A. Siegel  
Lawrence W. Smith

# Background Information and Basis for Conclusions

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## Introduction

BC1. The following summarizes the PCC's considerations in reaching the conclusions in this Update. It includes the Board's basis for endorsing the PCC's conclusions when needed to supplement the PCC's considerations. It also includes reasons for accepting certain approaches and rejecting others. Individual PCC members and Board members gave greater weight to some factors than to others.

## Background Information

BC2. The PCC received input through outreach that private companies often enter into receive-variable, pay-fixed interest rate swaps to economically convert a variable-rate borrowing to a fixed-rate borrowing. 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 (the swap rate) on the notional amount of the swap. The variable rate paid on the borrowing is offset by the variable rate received from the swap counterparty; however, the company still has to pay the agreed upon fixed rate on the swap (and any credit spread on the borrowing). In effect, the interest rate swap fixes the interest rate associated with the borrowing and mitigates the exposure to the risk of changes in cash flows due to changes in interest rates.

BC3. Topic 815 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 volatility of recording a swap's change in fair value, Topic 815 permits an entity to elect hedge accounting if certain requirements are met. Those requirements include formal designation and concurrent documentation at hedge inception and periodic assessments of hedge effectiveness. For a perfectly matching swap and borrowing, application of cash flow hedge accounting results in presenting interest expense in the income statement as if the entity had issued a fixed-rate borrowing.

BC4. 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 or the resources to prepare the documentation concurrently. Therefore, private companies may not elect to apply hedge

accounting, which results in income statement volatility because of changes in the fair value of the receive-variable, pay-fixed interest rate swap being recognized in earnings without any further accounting entries to reflect that the private company has economically converted its variable-rate borrowing into a fixed-rate borrowing by entering into that swap.

BC5. The PCC evaluated the derivatives and hedging accounting guidance in Topic 815 for receive-variable, pay-fixed interest rate swaps under the recognition and measurement module of the Private Company Decision-Making Framework to determine whether current U.S. GAAP requirements provide relevant information to users of private company financial statements at a reasonable cost. The PCC observed that the Private Company Decision-Making Framework places more weight on the considerations that address user relevance.

BC6. Since the issuance of the derivatives and hedging accounting guidance, many preparers and users (especially lenders) of private company financial statements have voiced concerns about the accounting for interest rate swaps and the related volatility in the income statement in the absence of applying hedge accounting. The PCC considered feedback from private company stakeholders through various channels, including (a) direct outreach to private company stakeholders, (b) nonpublic entity roundtables conducted by the Board, (c) written submissions to the Blue-Ribbon Panel on Standard Setting for Private Companies and the Financial Accounting Foundation's Plan to Establish a Private Company Standards Improvement Council, and (d) the Private Company Financial Reporting Committee. Considering the difficulties faced by private companies in electing hedge accounting, those stakeholders stated that a simplified alternative accounting approach should be provided for private companies that enter into swaps for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing.

BC7. On the basis of input received from users and preparers of private company financial statements, from public accountants, and from various other forums, the PCC decided to add to its agenda a project that would explore potential accounting alternatives for receive-variable, pay-fixed interest rate swaps that are entered into for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing. On July 1, 2013, the Board issued an Exposure Draft offering 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 Board received 37 comment letters addressing questions included in the Exposure Draft. Because of concerns raised in outreach with various stakeholders, the PCC decided to separate the combined instruments approach from the original proposal and directed the FASB staff to conduct further research on the combined instruments approach. In addition, the PCC decided to finalize the simplified hedge accounting approach. Significant changes from the original simplified hedge



accounting approach proposal are discussed throughout this basis for conclusions.

## Scope and Other Considerations

BC8. The PCC decided that the scope of this Update should be consistent with the scope of the Private Company Decision-Making Framework with the exception of financial institutions. That scope includes all entities, except for public business entities, not-for-profit entities, and employee benefit plans within the scope of Topics 960 through 965 on plan accounting. The PCC decided to exclude financial institutions from the scope of this Update considering that those entities generally use numerous derivative instruments recorded at fair value and, therefore, introducing the concept of settlement value for certain types of swaps could be confusing to users. The PCC concluded that financial institutions generally also have adequate resources to comply with the current U.S. GAAP requirements in Topic 815. Furthermore, the PCC noted that application of the scope exception in paragraph 825-10-50-3 to swaps accounted for under the simplified accounting approach may not be appropriate for financial institutions considering their greater exposure to financial instruments and the relevance of fair value accounting for those instruments. The Board and the PCC acknowledge that decisions about whether an entity may apply permitted alternatives within U.S. GAAP for private companies may ultimately be determined by regulators, lenders, and other creditors or other financial statement users that require U.S. GAAP financial statements.

BC9. The PCC deliberated whether swaps other than “plain-vanilla” swaps should be allowed use of the simplified hedge accounting approach. The PCC decided to limit the simplified hedge accounting approach to a narrow set of circumstances such that the approach addresses the prevalent practice issue of a private company entering into a “plain-vanilla” receive-variable, pay-fixed interest rate swap for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing. As such, the PCC observed that use of other than “plain-vanilla” swaps may reflect more sophisticated structured financing arrangements that would not provide the sufficiently narrow set of circumstances to apply the simplified hedge accounting approach.

BC10. The PCC decided to allow interest rates other than benchmark interest rates in applying the simplified hedge accounting approach. In the United States, currently only the interest rates on direct Treasury obligations of the U.S. government, the Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate), and, for practical reasons, the LIBOR swap rate are considered benchmark interest rates under Topic 815. The PCC acknowledged that swaps are most commonly based on benchmark interest rates and, in a vast majority of the circumstances under which the private company enters into a swap to economically convert a variable-rate borrowing into a fixed-rate borrowing, that swap is generally a “plain-vanilla” swap. However, to address

instances in which the private company may have a borrowing based on an interest rate that is not considered a benchmark (for example, Prime Rate) and a corresponding swap based on that same index, the PCC decided that as long as the borrowing and the swap are based on the same index and reset period, even if that index is the Prime Rate or any other interest rate that is not considered a benchmark, application of the simplified hedge accounting approach should be permitted.

BC11. The PCC noted that including an interest rate floor in borrowings during periods of low interest rates is not uncommon and does not contradict the objective of economically having a fixed-rate borrowing. Similarly, in a high-interest environment, a cap on interest rates could be included. Therefore, the PCC also allowed application of the simplified hedge accounting approach when a floor or a cap feature is included in the swap but only when there is a comparable provision in the borrowing. The PCC noted that, for this purpose, comparable does not necessarily mean equal. For example, if the swap's variable rate is LIBOR and the borrowing's variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the borrowing.

BC12. The PCC acknowledged that under Topic 815 cash flow hedges 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. In reaching that decision, the PCC observed that it is not uncommon under current U.S. GAAP for a forecasted transaction involving a forward-starting swap to be deemed perfectly effective using an approach such as the hypothetical-derivative method. The PCC noted that, assuming an entity still meets the other criteria in paragraph 815-20-25-131D, the removal of a criterion prohibiting forward-starting swaps provides private companies with a practical expedient to apply hedge accounting in arrangements that, under current U.S. GAAP, would likely be assessed to be highly effective. In addition, the PCC noted that when the forecasted interest payments are no longer probable of occurring, a cash flow hedging relationship will no longer qualify for the simplified hedge accounting approach. At the time of such disqualification (that is, dedesignation), the gain or loss on the swap in accumulated other comprehensive income will be reclassified to earnings in accordance with paragraphs 815-30-40-1 through 40-6 with the swap measured at fair value on the date of change and subsequent changes in fair value reported in earnings in accordance with paragraph 815-10-35-2.

BC13. The PCC obtained feedback that the requirements in paragraph 815-20-25-131D(d), which states that the swap's fair value at inception must be at or near zero, are not clear as to whether *at or near zero* would include related transaction costs or initial up-front payments. The PCC decided that the fair value of the swap may be other than zero (that is, near zero) at the inception of the hedging relationship only if the swap was entered into at the relationship's inception, the transaction price of the swap was zero in the entity's principal

market (or most advantageous market), and the difference between transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction.

BC14. The PCC obtained stakeholder feedback that the original simplified hedge accounting approach proposal was unclear as to whether the simplified hedge accounting approach would be permitted for arrangements in which borrowers have the option to select the interest rate index (for example, LIBOR, Prime) and/or the reset frequency (for example, monthly, quarterly). To be consistent with the PCC's intent in the original simplified hedge accounting approach proposal, a variable-rate borrowing with an option to select the interest rate index will not automatically disqualify a preparer from utilizing the simplified hedge accounting approach as long as both the interest rate and reset period on the swap and the interest rate and reset period on the borrowing are based on the same index and reset period at the inception of a receive-variable, pay-fixed interest rate swap arrangement. If in subsequent reporting periods the borrower elects a change in the index and reset period to a rate that is different from that in the swap contract, the relationship will no longer qualify for the simplified hedge accounting approach because the condition in paragraph 815-20-25-131D(a) is no longer met. At the time of such disqualification (that is, dedesignation), the gain or loss on the swap in accumulated other comprehensive income will be reclassified to earnings in accordance with paragraphs 815-30-40-1 through 40-6 with the swap measured at fair value on the date of change and subsequent changes in fair value reported in earnings in accordance with paragraph 815-10-35-2.

BC15. The PCC noted that the provision of "a few days" in paragraph 815-20-25-131D(c) does not require further elaboration; instead, application of that phrase may be left up to practice to determine in applying the alternative approaches. In carrying out that determination, the PCC observed that "a few days" is not intended to provide a blanket or extended period of exception from the criterion that "the repricing and settlement dates for the swap and the borrowing match" but is provided only as a means to address administrative or other practicability concerns. The PCC noted that this approach is preferable to specifying any bright-line threshold, for example, a difference of no more than five days.

BC16. As originally stated in the proposal, private companies applying the approach would have had up until within "a few weeks" to complete the documentation required by paragraph 815-20-25-3. The PCC obtained stakeholder feedback that completing documentation within "a few weeks" could be an administrative burden for private companies because many do not consider the accounting implications of significant contracts such as long-term debt and swap agreements until preparing the annual financial statements. In addition, the PCC observed that many private companies lack the expertise and accounting resources and may require the assistance of a public accountant or a third party to comply with the documentation requirements in Topic 815. The

PCC considered whether additional time for formal hedge documentation could provide private companies with an opportunity to “look back” on the performance of the swap and then decide whether to apply hedge accounting to potentially manage earnings. In considering that viewpoint, the PCC noted that private company financial statement users may focus on different key operating metrics than what public company financial statement users focus on. Users of private company financial statements, for example, generally focus on adjusted earnings before interest, taxes, depreciation, and amortization (EBITDA), a measure that excludes interest expense. While many public company financial statement users also focus on adjusted EBITDA, many also focus on earnings per share, a measure derived from net income that includes the effect of interest expense. Furthermore, the lender to a private company may be its primary financial statement user and, therefore, may have greater access to information about the swap transaction in instances in which the lender facilitated the swap transaction or is the swap counterparty. The PCC decided that the potential benefits to private companies in terms of relief in the application of hedge accounting ultimately outweigh the shortcomings of the ability to “look back” on the performance of the swap. As such, the PCC decided that in applying the simplified hedge accounting approach, the documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed by the date on which the first annual financial statements are available to be issued after hedge inception. The PCC noted that this relief is provided as a means to address the administrative and practicability concerns that were received through stakeholder feedback.

BC17. The PCC received stakeholder feedback expressing concern about the use of settlement value in situations in which the swap counterparty’s credit position deteriorates after the inception of the swap arrangement. The use of settlement value, for example, could significantly overstate a swap asset when a borrower expects to receive payments from a swap counterparty with high credit risk. The PCC noted that the current guidance in Topic 815 addresses that concern. That is, the effectiveness of the swap in economically converting a variable-rate borrowing into a fixed-rate borrowing involves assessing the likelihood of the counterparty’s compliance with the contractual terms of the swap. As such, to initially (and subsequently) qualify for the simplified hedge accounting approach, a private company would have to satisfy the requirements in Topic 815 regarding the consideration of counterparty credit risk and the possibility of default by the counterparty to a hedging derivative.

BC18. The PCC decided to address scope requirements in Topic 825, which provides guidance on required disclosures about the fair value of financial instruments for assets and liabilities that are not measured at fair value in the statement of financial position for which it is practicable to estimate fair value. In accordance with paragraph 825-10-50-3, entities are exempt from Topic 825 fair value disclosures only if all of the following conditions are met:

- a. The entity is a nonpublic entity.

- b. The entity's total assets are less than \$100 million on the date of the financial statements.
- c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under Topic 815 other than commitments related to the origination of mortgage loans to be held for sale during the reporting period.

For the purpose of evaluating whether Topic 825 disclosures about the fair value of financial instruments are required, the PCC decided that a swap recorded under the simplified hedge accounting approach is not considered a derivative instrument under Topic 815. In reaching that decision, the PCC observed that one of the general principles behind the scope exception in paragraph 825-10-50-3 is to exempt nonpublic entities that are not engaged in complex financial transactions from additional disclosure requirements related to the fair value of financial instruments. Because the types of swaps accounted for under the simplified hedge accounting approach are commonly used by private companies, the PCC believes that those swaps do not represent complex financial transactions and, therefore, should not trigger additional fair value disclosure requirements.

## Transition and Early Adoption

BC19. The PCC decided that entities within the scope of this Update should be provided with an option to apply the amendments in this Update using either one of the following approaches:

- a. A modified retrospective approach in which corresponding adjustments should be made 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 receive-variable, pay-fixed interest rate swap was entered into (or acquired) by the entity.
- b. A full retrospective approach in which financial statements should be adjusted 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 and corresponding adjustments should be made to the assets, liabilities, and opening balance of accumulated other comprehensive income and retained earnings (or other appropriate components of equity) of the earliest period presented to reflect application of hedge accounting from the date the receive-variable, pay-fixed interest rate swap was entered into (or acquired) by the entity.

The PCC noted that the option for a full retrospective transition should provide entities within the scope of this Update with the ability to present consistent

accounting for similar transactions occurring in prior periods presented, thereby facilitating comparability within the entity's financial statements.

BC20. The PCC decided to allow application of the simplified hedge accounting approach to existing swaps that meet the qualifying criteria on a swap-by-swap basis. The election to apply the simplified hedge accounting approach to an existing swap should be made upon adoption of the amendments in this Update.

BC21. The PCC noted that as a one-time transition amendment, the condition that the swap's fair value at the time of application of the simplified hedge accounting approach is at or near zero need not be considered. Instead, as long as the swap's fair value was at or near zero at the time the swap was entered into (or acquired) by the entity, application of the simplified hedge accounting approach to existing swaps should be permitted. In applying the simplified hedge accounting approach to existing swaps, the documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed in the period of adoption of the amendments in this Update by the date on which the first annual financial statements are available to be issued rather than concurrently at hedge inception. The PCC noted that allowing application of the simplified hedge accounting approach to existing swaps should address concerns about the accounting for those swaps and the related volatility in the income statement in the absence of applying hedge accounting.

BC22. The PCC decided to permit early application of the amendments to benefit entities within the scope of this Update as soon as is practicable.

## Effect on User-Relevance and Cost under the Private Company Decision Framework

BC23. The objective of financial reporting is to provide information that is useful to present and potential users in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. The Private Company Decision-Making Framework provides considerations for the PCC and the Board in making user-relevance and cost-benefit evaluations for private companies under the existing conceptual framework. The Private Company Decision-Making Framework is a tool to help the Board and the PCC identify differential information needs between users of public company financial statements and users of private company financial statements and to identify opportunities to reduce the complexity and costs of preparing financial statements in accordance with U.S. GAAP. The PCC's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC24. The amendments provide entities within the scope of this Update with a practical expedient to apply cash flow hedge accounting for receive-variable, pay-fixed interest rate swaps that are entered into for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing, thus mitigating private company stakeholders' concerns about the costs and complexity of qualifying for hedge accounting treatment in those circumstances. Because the periodic income statement charge for interest expense under the simplified hedge accounting approach is similar to the amount that would result if the entity had directly entered into a fixed-rate borrowing instead of a variable-rate borrowing and a receive-variable, pay-fixed interest rate swap, the amendments in this Update reduce income statement volatility and address private company stakeholders' concerns about the difficulty in understanding and applying the hedge accounting model in such circumstances while still providing relevant information.

BC25. The amendments in this Update will allow the swap to be subsequently measured at its settlement value instead of fair value when applying the simplified hedge accounting approach. The PCC obtained feedback that the primary difference between settlement value (that is, the amount to be paid to or received from the swap counterparty to terminate the swap) and fair value is that generally the nonperformance risk of the swap counterparties is not considered in determining the settlement value amount. Because settlement value is generally easier to determine in comparison to fair value, the PCC concluded that it should alleviate the cost and complexity concerns that have been raised by some private company stakeholders with regard to estimating fair value.

BC26. Overall, the simplified hedge accounting approach simplifies the accounting for certain types of swaps and is responsive to the needs of private company stakeholders. The alternative approach will continue to provide decision-useful information to users of private company financial statements, while providing a reduction in the cost and complexity in accounting for certain swaps. Therefore, the amendments meet the overall objective of the Private Company Decision-Making Framework for addressing the needs of private company stakeholders.