

Insights

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A biweekly audit and accounting publication

Accounting

Accounting for Leases: Its Time Has Come

The topic of accounting for leases has had a bullseye on its back for decades. Lease accounting is a form-driven standard. Minor changes to the provisions of a lease contract will result in an accounting outcome that suits the parties to the transaction without affecting, in a significant way, the underlying economics. Thus, lease accounting has been one of the most, if not the most, gamed accounting pronouncements of all times. Because of this, the Financial Accounting Standards Board (FASB) has been frequently requested to place this topic on its agenda. However, for a variety of reasons, the FASB historically has declined to do so. Instead, various so-called stop-gap measures have been issued, such as Interpretations, Technical Bulletins and FASB Staff Positions. Also, this has been a frequent topic on the agenda of the Emerging Issues Task Force. Some of those stop-gap measures have resulted in requiring a lessee to consolidate a lessor to better reflect the economics of a transaction when the application of the form-driven requirements of FASB Statement No. 13, *Accounting for Leases*, failed to do so.

A little background information might be helpful in understanding how the accounting has evolved over time. The topic of lease accounting was first discussed in an Accounting Research Bulletin by the Accounting Research Committee (ARC). The ARC was subsequently replaced by the Accounting Principles Board (APB). The APB issued four Opinions on lease accounting during the period 1964 to 1973; they were APB Opinions 5, 7, 27 and 31. The APB was the predecessor to the FASB. Generally, those APB Opinions required that leases be accounted for based on their substance without any "brightlines" provided to do so. It was essentially built on a benefits and rewards model. In response to the criticism about the lack of definitive guidelines to assist financial statement preparers and their auditors to properly assess the appropriate accounting for lease contracts, the FASB issued Statement No. 13 in 1976. At its issuance, Statement No. 13 helped resolve the difficulties in lease accounting by prescribing certain "brightline" tests that, if met, resulted in the lessee having a lease recognized as an asset and liability on its financial statements, or the lessor recognizing a sale or financing of the underlying leased asset. But, with minor tinkering with the terms of the lease (and without disturbing the underlying economics), a lessee would be able to remove the lease from its balance sheet even before it got there.

In responding to constituent requests over the years to reconsider the guidelines for lease accounting, various Board members would comment in public speeches to be careful what you ask for because you might not like what you get. Nevertheless, in response to continuing requests, on July 19, 2006 the FASB agreed to place the topic of lease accounting on its active agenda. This will be a joint undertaking with the International Accounting Standards Board (IASB). The objective of the project is to comprehensively reconsider Statement No. 13 so as to ensure that investors and other users of financial statements are provided useful, transparent, and complete information about leasing transactions in the financial statements.

The FASB held its first Board meeting on March 21, 2007 at which lease accounting guidance was debated. That discussion focused on assets and liabilities arising in a simple lease contract and a staff analysis of different possible accounting models. It is way too early to predict the direction this project will take (it may take several different directions before any final decisions are reached) or its timing. For example, will the FASB ultimately decide that any lease contract having a term over 30 days (or, perhaps, one year) results in the recognition of one or more assets and one or more liabilities by a lessee?

Since essentially every business and nonbusiness entity enters into lease contracts, this project will most assuredly affect most everyone. The purpose of this article is to alert you that this project is now moving forward. The FASB, in consultation with the IASB, will likely issue a Preliminary Views document to update constituents on the Board's current thinking and to solicit feedback on its preliminary decisions. After that, an Exposure Draft will be issued, which means the Board has gotten itself more deeply entrenched (but not inextricably so) in its decisions. Stay tuned for future developments as they occur. Future issues of Insights will have articles summarizing major developments. And, affected entities are encouraged to participate in the debate as their financial statements will be affected, perhaps materially so.

Derivatives: Reminder No. 2

This article is the second in a series of three biweekly articles presenting reminders about important basic requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The March 15 edition of Insights featured Reminder No. 1: Look for the Derivative. This week we present a reminder about the documentation required to elect hedge accounting once a contract or financial instrument has been determined to meet the definition of a derivative.

Reminder No. 2 - Document the Hedge

Many companies would like to elect the privilege of hedge accounting treatment allowed by Statement No. 133 (designating transactions as fair value hedges, cash flow hedges, or foreign currency hedges), but not all companies are diligent in meeting the requirements to do so. Yes, hedge accounting is a privilege. Statement No. 133 requires that certain criteria be met for all types of hedges to qualify for hedge accounting. There also are additional criteria that are unique to each specific type of hedge.

To qualify for hedge accounting, hedge documentation must be prepared at inception of the hedging relationship. Inadequate or incomplete documentation, in and of itself, will disqualify a company from applying hedge accounting. To sufficiently meet the requirements in Statement No. 133, formal hedge documentation must contain the following, at a minimum:

- A description of the hedge item or transaction;
- A statement designating which type of hedge accounting is being followed;
- A description of the hedging instrument that is sufficiently specific so that when a transaction occurs, it is clear whether that particular transaction is the hedged transaction;
- A statement of the intended hedge objective, including a discussion of the nature of the risk being hedged and any related hedge strategy or methodology;
- A discussion explaining how the hedging instrument's retrospective and prospective effectiveness in offsetting the change in fair value or cash flows associated with the hedge risk will be assessed, including reference to any components of a specific hedging derivative's gain or loss that will be excluded from the assessment of hedge effectiveness; and
- A discussion of the method that will be used to measure hedge ineffectiveness.

The method used to assess effectiveness and measure ineffectiveness should be described with sufficient specificity so that a third party could perform the assessment or measurement based on the documentation and arrive at the same result. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective during the term of the hedge. The final biweekly article in this series will remind us about measuring hedge effectiveness accurately and periodically.

Proper Use of the Critical-Terms-Match Method for Evaluating Hedge Effectiveness

To qualify for hedge accounting under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, hedge documentation must include an explanation of how the hedging instrument's retrospective and prospective effectiveness in offsetting the change in fair value or cash flows associated with the hedge risk will be assessed. The hedging relationship is expected to be highly effective during the term of the hedge. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. Entities may not have to perform a detailed hedge-effectiveness analysis, however, if the critical terms of the hedging instrument and the hedged item are the same. This effectiveness analysis is called the "critical-terms-match" method. This method allows entities to assume that the hedge is 100% effective.

At the December 2006 AICPA SEC Conference, the SEC staff indicated that they found entities were incorrectly applying the critical-terms-match methodology. The SEC staff believes that any terms that do not match, and therefore may cause ineffectiveness, need to be considered when applying the critical-terms-match method. In certain circumstances entities assumed that minor differences in terms would not cause a hedge to fall out of effectiveness but did not include their assessment in the hedging documentation. The SEC staff indicated that the lack of documentation of such assessments would cause the entity to fall out of hedge accounting.

However, at the March 15, 2007 meeting of the Emerging Issues Task Force (EITF), the SEC staff provided relief to their previous statement in certain situations. It should be noted that this relief is considered a very narrow scope and should not be applied by analogy. The SEC staff described an approach for evaluating the effectiveness of cash flow hedges under the critical-terms-match method when all critical terms do not exactly match due to timing issues. This would include situations when the settlement dates of a swap do not match the settlement dates of hedged debt. In addition, the SEC staff also provided certain parameters in performing assessments of hedges of forecasted foreign-currency-denominated transactions in which the forecasted transactions occur over a stated period (i.e., monthly or quarterly) but the hedging instrument settles once during the period. It may be reasonable to conclude (pending the outcome of the quantitative assessment) that the terms are "essentially matched" when the hedging instrument and the hedged transactions settle within one month of each other. However, when settlement is outside of a one-month window, SEC registrants should discuss the situation with the SEC staff.

According to the staff, hedgers who used the critical-terms-match method and have timing differences should confirm the basis for their assertion that ineffectiveness will be de minimis by making a quantitative assessment. Hedgers should:

- Revisit their existing critical-terms-match hedging relationships and confirm the reasonableness of their original assessments (i.e., that the hedging relationship is, in fact, highly effective, and that any ineffectiveness is de minimis).
- If they haven't already, make a quantitative assessment to determine that ineffectiveness has been de minimis.
- If the results of this analysis support the reasonableness of a hedger's original conclusion that the hedging terms are "essentially matched," then it should continue with its application of the critical-terms-match hedge accounting.

All of the above should be appropriately documented and previously existing hedging documentation should be appended appropriately.

These recent statements by the SEC staff followed discussions held by the staff with representatives of major accounting firms and members of the Financial Executives International's Committee on Corporate Reporting in January and March. Jolene Hart, a partner in the McGladrey & Pullen, LLP National Office of Audit and Accounting, participated in the discussions held with the SEC staff. She observed, "The critical-terms-match method remains a viable option for assessing hedge effectiveness; however sources of potential ineffectiveness must be evaluated both qualitatively and quantitatively. Documentation of these evaluations on an ongoing basis will be critical to maintaining the privilege of hedge accounting treatment allowed by Statement No. 133."

While the above discussions with the SEC staff were part of an informal announcement and not formally distributed, the announcement is expected to be included in the minutes of the March 15, 2007 EITF meeting, which will be posted at www.fasb.org.

Business Combinations Project Nears Completion

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) are nearing completion of their joint project, Business Combinations: Applying the Acquisition Method. They are working together to develop an accounting standard for business combinations that could be used for both domestic and cross-border financial reporting. The standard, which is scheduled to be issued during the second quarter of this year, would replace the existing requirements of International Financial Reporting Standard (IFRS) 3, Business Combinations, and FASB Statement No. 141, *Business Combinations*.

The joint proposals to improve and align the accounting for business combinations were issued in an Exposure Draft in June of 2005. The principal changes proposed included a requirement to measure the business acquired at fair value and to recognize the goodwill attributable to any non-controlling interests (previously referred to as minority interests) rather than just the portion attributable to the acquirer. Since then, the proposals in the Exposure Drafts have been and continue to be redeliberated by both Boards.

The Boards have retained the fundamental requirement of IFRS 3 and Statement No. 141 to account for all business combinations using a single method—where one party is always identified as acquiring the other. They have agreed that by obtaining control of an acquiree, an acquirer becomes responsible and accountable for all of the acquiree's assets, liabilities, and activities, regardless of the percentage of its ownership in the acquiree. In a business combination, the acquirer then should recognize all of the assets acquired and all of the liabilities assumed, measuring each recognized asset acquired and each liability assumed at its acquisition-date fair value. The Boards also have agreed that acquisition-related costs, such as legal and due diligence costs, should be accounted for as expenses when incurred rather than capitalized as part of the business combination. Debt or equity issuance costs, however, should be accounted for under other relevant generally accepted accounting principles.

The IASB and the FASB also have affirmed their proposals in separate Exposure Drafts, which stated that noncontrolling interests in subsidiaries should be presented in the consolidated balance sheet within equity, separate from the parent shareholders' equity. Any acquisitions or dispositions of noncontrolling interests that do not result in a change of control should be accounted for as equity transactions. These concepts would amend International Accounting Standard 27, *Consolidated and Separate Financial Statements*, and would replace Accounting Research Bulletin No. 51, *Consolidated Financial Statements*.

The Boards are nearing the end of Project redeliberations, which will continue to take place in April. The major issues yet to discuss are contingent consideration, disclosures and the effective date for the Standard. For complete details about the Project, go to http://www.fasb.org/project/bc_acquisition_method.shtml.

Auditing

ASB Gets In Sync with International Standards

The Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) has developed a plan to harmonize U.S. generally accepted auditing standards (GAAS) with International Standards on Auditing (ISAs). The ASB began this plan by harmonizing its standard-setting agenda with that of the International Auditing and Assurance Standards Board (IAASB). Since formalizing its plans to harmonize GAAS with the ISAs, the ASB has issued several standards that are either based on the ISAs or were developed jointly with the IAASB. The most notable are the suite of risk assessment standards - Statements on Auditing Standards (SAS) Nos. 104 -111. Using the ISAs as a base, the ASB also has issued SAS No. 103, Audit Documentation, and SAS No. 114, The Auditor's Communication With Those Charged With Governance. Other projects underway that will use the ISAs as a base include: revision of the auditor's report to more clearly explain the auditor's responsibilities and management's

responsibilities, revision of the related-parties standard to apply a risk-based approach, and revision of the use of specialists and management representations standards.

The IAASB is currently involved in a significant effort to clarify the ISAs. The purpose of that effort is to address concerns about the clarity of the ISAs as well as their length and complexity. The ASB has concluded that “clarifying” GAAS by issuing the standards in a different format and style will make them more understandable, clearer, and capable of more consistent application. A discussion paper seeking comment on certain issues related to the structure, format, and style of the standards will be available in early April 2007 on the AICPA Web site. The ASB will be asking readers to study the proposed new style and format of the standards and comment on their preferences prior to May 31, 2007.

Public Sector

Proposed Accounting for Land and Other Real Estate Held as Investments by Endowments

Current accounting standards require permanent and term endowments, which exist to invest resources for the purpose of generating income, to report land and other real estate held as investments at historical cost. In contrast, other entities such as pension and other postemployment benefit plans, external investment pools, and certain deferred compensation plans, which exist for similar income-generating purposes, report land and other real estate held as investments at their fair value. Also, other investments such as corporate stock and bonds, which are held for similar purposes by comparable entities, are reported at fair value.

Recently, the Governmental Accounting Standards Board issued a proposal to establish consistent standards for the reporting of land and other real estate held as investments by essentially similar entities. The proposed Statement would require permanent and term endowments and permanent funds to report the fair value of land and other real estate held as investments and the changes in that fair value. The Statement also would require disclosure of the methods and significant assumptions employed to determine fair value, as well as other information that currently is presented for other investments reported at fair value. The requirements of the proposed Statement would be effective for financial statements for periods beginning after June 15, 2008.

The proposed statement is available for comment until June 29, 2007 at http://www.gasb.org/exp/ed_endowments.pdf.

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