



Accounting & Auditing Information Letter 07-039

FASB Meeting - October 17, 2007

October 19, 2007

THE SUMMARY IN THIS MEMORANDUM IS BASED ON OBSERVATIONS OF THE MEETING AND REPRESENTS AN UNOFFICIAL INTERPRETATION OF THE DISCUSSION.

The Board discussed the following matters:

- (1) Conceptual Framework – The Board agreed in principal on the definition of an asset, which the staff will draft and present to the Board. This definition will be used as the staff proceeds with other aspects of Phase B of the Conceptual Framework project.
- (2) Leases – The Board deliberated issues about (a) certain lease obligations other than rental payments (other lessee obligations) and (b) variable lease payments. The Board directed the staff to research broader leasing issues before addressing specific matters related to those issues. The meeting was informational and the Board did not make any decisions.
- (3) Statement 133 Hedging – The Board discussed the proposed fair value accounting model for fair value hedges. The Board reached decisions about the scope of the project, specific requirements for hedge accounting, and measurement criteria of the hedged item.
- (4) Effective Date of Statement 157 – The FASB decided not to comprehensively delay the effective date of FASB Statement No. 157, *Fair Value Measurements*, and directed the staff to analyze selectively deferring the Statement’s effective date.
- (5) Effective Date of SOP 07-1 – The FASB decided to propose an indefinite delay of the effective date of AICPA Statement of Position No. 07-1, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, which defines investment company for purposes of applying the industry accounting in the AICPA Audit and Accounting Guide, *Investment Companies*.

Summary

1. Conceptual Framework

The Board agreed in principal on the definition of an asset, which the staff will draft and present to the Board. This definition will be used as the staff proceeds with other aspects of Phase B of the Conceptual Framework project.

Specifically, the Board discussed and agreed on the following recommendations from the staff:

- (a) The focus of the definition of an asset should be on a present economic resource rather than on future economic benefit.
- (b) Any assessment of likelihood should be removed from the definition of an asset.
- (c) The phrase “capable of producing cash inflows or reducing cash outflows” should be eliminated from the asset definition as it is an incomplete description of what constitutes an economic resource. Further, the Board agreed that the definition of an economic resource should accompany the asset definition. A definition of an economic resource is “something that is scarce and capable of producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources.”
- (d) A focus on the present is preferable to focusing on past transactions or events.
- (e) The term “control” should be replaced. The Board agreed in principle that a present economic resource exists by a virtue of the enforceable right or other access (where access encompasses an entity's access to the resources as well as precludes others from having that access). The staff will complete the drafting of the working definition and will present it to the Board in the next meeting.

2. Leases

The Board deliberated issues about (a) certain lease obligations other than rental payments (other lessee obligations) and (b) variable lease payments. The meeting was informational and the Board did not make any decisions.

(a) – Other Lessee Obligations

Issue 1: Recognition

The staff presented three types of other lessee obligations for discussion. For each type of other lessee obligation the Board discussed the following questions:

- (1) Do the obligations meet the definition of a liability for the lessee?
- (2) If yes to Question 1, when does the liability arise (i.e., when should it be recognized)?

(3) Where is the offsetting debit recorded (e.g., expense or part of the cost of the right to use asset)?

Type 1 – Lessee obligations to return the leased item

Staff Recommendation: The staff expressed the view that these obligations meet the definition of a liability and should be recognized when the lessee obtains access to the leased item (in the case of transportation costs) or when the machinery is installed (in the case of an obligation to dismantle. The staff did not express a view on the accounting for the offsetting debit.

Board Discussion: Some Board members expressed agreement with the staff view, but the Board made no decision. The Board discussed two possible models for recording the debit: (1) cost accumulation model (i.e., capitalize) or (2) fair value model (i.e., expense), but did not express a preference.

Type 2 – Lessee obligation to return the leased item in a specified condition

Staff Recommendation: The staff expressed the view that these obligations meet the definition of a liability and should be recognized either when the leased item is delivered or made available to the lessee, or when the condition of the leased items falls below the contractually specified condition. The staff did not express a view on the accounting for the offsetting debit.

Board Discussion: Most Board members agreed with the staff view that these obligations meet the definition of a liability, but the Board made no decision. Some Board members suggested that these obligations should be recognized when the condition of the leased item falls below what is required by the lessor. For example, if the lessee is required to perform maintenance at 15,000 machine hours, an obligation would be recognized only when 15,000 machine hours is reached. During the discussion, the Board noted that under that recognition approach different accounting results could arise depending on whether the costs are paid by the lessee or by the lessor and recovered through the fixed lease payments. The Board did not express a preference for the timing of liability recognition. The Board made the same observations with respect to the accounting for the debit as it did for Type 1 obligations without expressing any preference.

Type 3 – Obligations to maintain the leased item

Staff Recommendation: The staff expressed the view that these obligations meet the definition of a liability but did not express a view with respect to the timing of recognition or the accounting for the offsetting debit to the liability.

Board Discussion: The Board observed that Types 2 and 3 are similar in nature and discussed them together. See summary under Type 2 above.

Issue 2: Initial and Subsequent Measurement

Staff Recommendation: The staff expressed the view that other lessee obligations (Types 1, 2, and 3) should be measured initially at fair value. The staff also suggested that subsequent measurement at fair value would provide the most relevant information to financial statement users but noted that this would be a departure from the Board's tentative decision in June 2007 related to the measurement of the lessee's lease obligation (i.e., at amortized cost with optional fair value measurement).

Board Discussion: The Board discussed the staff's views and also discussed whether initial and subsequent measurement should be based on the expected cost to settle the obligation. The Board did not express a preference for a particular measurement model.

Issue 3: Assets for the Lessor

Terms in a lease contract that require a lessee to either return the leased item to the lessor in a specified condition or maintain the leased item create valuable rights for the lessor when combined with either the lessor's interest in the leased item at the end of the lease or its right to receive payments from the lessee.

Staff Recommendation: The staff expressed the view that these rights are not a separate asset of the lessor, but would impact the measurement of the lessor's interest in the residual value of the leased item at the end of the lease.

Board Discussion: Most of the Board members expressed agreement with the staff's view but the Board was not asked to reach a conclusion.

(b) – Variable Lease Payments

The staff analyzed the accounting for three categories of variable lease payments. For each category, the Board discussed the following questions:

- (a) Should the lessee recognize a liability for the fixed and variable components of the future rentals?
- (b) If yes for Question 1, what is the initial and subsequent measurement for the lessee's obligation?
- (c) Should the lessor recognize a receivable for the fixed and variable components?

Category 1 – Lease payments with a variable factor based on price changes or changes in an index (e.g., CPI)

Staff Recommendation: The staff expressed the view that the lessee should recognize a liability for both the fixed and variable portions of future rentals at lease inception. The staff further expressed the view that the liability should be initially measured at fair value, and subsequently measured either at fair value or an adjusted carrying amount based on changes in expected rentals (discounted using the interest rate used for initial measurement). In addition, the staff expressed the view that the lessor should recognize an asset for both the fixed and variable portions of future rentals at lease inception. However, the staff did not express a view on the measurement of the lessor's asset.

Board Discussion: Most Board members expressed agreement with the staff view, but the Board was not asked to reach any conclusions. The Board discussed, but did not express any preferences regarding the initial and subsequent measurement of the lessee's obligation or for the lessor's accounting for the variable payments. The Board asked the staff to further explore the measurement issues involved (for both liabilities and assets), including the appropriate unit of account (i.e., whether to separately account for fixed versus variable components of required lease payments) and the income statement effects of the staffs views.

Category 2 – Lease payments with a variable factor based on the lessee’s financial or operating performance from the leased item

Staff Recommendation: The staff expressed the view that the lessee should recognize a liability for both the fixed and variable portions of future rentals at lease inception but did not express any views regarding the initial and subsequent measurement of the lessee’s obligation or for the lessor’s accounting for the variable payments.

Board Discussion: Board members expressed mixed views about whether these obligations should be recognized when the performance target is achieved or at lease inception based on the lessee’s best estimate. The Board made no decisions. The Board discussed, but did not express any preferences regarding the initial and subsequent measurement of the lessee’s obligation or for the lessor’s accounting for the variable payments.

Category 3 – Lease payments with a variable factor based on the lessee’s usage

Staff Recommendation: The staff expressed the view that the lessee should only recognize a liability once its actual usage exceeded the usage limit and only for the amount due as a result of that excess usage at the measurement date. The staff also expressed the view that the lessor should recognize an asset when, and in the same manner as, the lessee recognizes its liability.

Board Discussion: Most Board members expressed agreement with the staff’s views, but the Board was not asked to reach any conclusions.

Overall Instructions for Staff

As a result of the discussion, a number of Board members expressed a desire for greater understanding about how overall issues affecting the lease accounting project might be resolved before being asked to conclude on the more detailed issues being raised by the staff. Those overall issues include:

- Whether there should be symmetry in the accounting by the lessor and lessee,
- What the appropriate unit of account is for the lease obligation of the lessee (i.e., whether there should be separate accounting for the various aspects of lease arrangements such as fixed and variable components of rentals),
- What the appropriate accounting model is for assets and liabilities under a lease,
- Whether the lessee should recognize a gain or loss upon entering into a lease, and
- The potential income statement ramifications of the above.

The Board directed the staff to research these issues further for discussion at future meetings.

3. Statement 133 Hedging

The Board discussed the proposed fair value accounting model for fair value hedges. The Board reached decisions about the scope of the project, specific requirements for hedge accounting, and measurement criteria of the hedged item. The Board decisions will assist

the FASB Staff in completing the development of the fair value accounting model for fair value hedges.

The Board decided to include in the scope, financial and non-financial assets and liabilities. The Board determined that the objective of the project should be to simplify the current Statement 133 guidance.

The Board discussed the proposed fair value model for fair value hedges as it related to the requirements for hedge accounting. The proposed model would require identification of the hedging instrument, identification of the hedged item, and a qualitative evaluation of the nature of the risk that the entity is attempting to hedge and why the derivative should be effective in offsetting changes in the fair value of the hedged item that result from the hedged risk. In order to qualify for hedge accounting, the qualitative evaluation must demonstrate that (a) a business purpose exists for the hedging relationship and (b) the derivative should be expected to reasonably offset changes in fair value of the hedged item related to the hedged risk.

The Board discussed whether assessing effectiveness should be required, and if so, (1) whether it should be based on a quantitative approach or a qualitative approach and (2) when and how often an entity should be required to assess effectiveness; late hedging; and revocability (ability to dedesignate and redesignate).

The Board decided that assessing effectiveness should be required as of the beginning of the hedge relationship to determine if hedge accounting is appropriate. This assessment should be based solely on the risk being hedged and changes in the total fair value of the hedged item and the hedging instrument would be marked to fair value on an ongoing basis. The Board also decided to formally re-evaluate effectiveness if current events suggest that the hedge is no longer effective.

The Board discussed late hedging which occurs when a transaction is designated at a date subsequent to the date on which the hedged item was initially recognized. The Board decided that a hedging relationship should be permitted to be designated at a date after initial recognition of the asset or liability.

The Board determined that a fair value hedge designation should be revocable and be designated, dedesignated, and redesignated at any time.

The Board discussed how to measure a hedged item under the fair value hedge accounting approach. The purpose was to resolve the issue of recognizing offsetting gains and losses in earnings in different periods as a result of measurement anomalies between the hedged item and hedging instrument. The Board decided to require the carrying value of the hedged item to be adjusted for changes in fair value during the hedge period.

4. Effective Date of Statement 157

The FASB decided not to comprehensively delay the effective date of FASB Statement No. 157, *Fair Value Measurements*, and directed the staff to analyze selectively deferring the Statement's effective date. Statement 157 is effective for fiscal years beginning after November 15, 2007 (January 1, 2008 for calendar-year companies).

The FASB authorized the staff to study the potential consequences of delaying Statement 157 for certain kinds of items subject to its measurement guidance and for entities meeting certain thresholds. The staff's conclusions and analysis, as well as a staff summary of significant financial-instrument implementation issues and implementation issues identified by the newly formed Valuation Research Group, will be considered by the FASB at future meetings.

See further discussion of the Board's decisions in Defining Issues 07-031, *FASB Retains Effective Date of Statement 157, Will Delay Effective Date of SOP 07-1*.

5. Effective Date of SOP 07-1

The FASB decided to propose an indefinite delay of the effective date of SOP 07-1, which defines investment company for purposes of applying the industry accounting in the Guide. The FASB delayed the effective date of SOP 07-1 indefinitely primarily because of concerns over implementation issues arising from the interaction between the SOP and Statements 157 and 159 as well as the short implementation period between its issuance on June 11, 2007 and its effective date. Board members agreed to add a project to the technical agenda to consider amending the SOP 07-1 to address implementation issues. A new effective date will be determined after the FASB addresses implementation issues and potential amendments.

See further discussion of the Board's decisions in Defining Issues 07-031, *FASB Retains Effective Date of Statement 157, Will Delay Effective Date of SOP 07-1*.

*The FASB issues a final summary of the Board's meeting on the Thursday following the meeting. The summary is included in its weekly publication, **Action Alert**, and is available at www.fasb.org. Generally accepted accounting principles are not amended, modified, rescinded, or enacted as part of the public meeting deliberations. The Statements in this summary pertain to projects still under consideration by the FASB. Nothing is intended to indicate how to comply with yet-to-be-issued FASB Statements. Companies addressing the provisions of the finally adopted Statements should base their accounting on the requirements applicable at the time they report and consultation with accounting and legal advisors.*