US Reporting Newsletter for Non-US Based Companies

Global Offerings Services

February-March 2005

Global Offerings Services (GOs) comprises a global team of practitioners assisting non-US companies and non-US practice office engagement teams in applying US and International accounting standards (i.e., US GAAP and IFRS) and in complying with the SEC's financial reporting rules. For more information please contact the GOs Center leader nearest you.

New York – Joel Osnoss
+1 (212) 436 3352

Hong Kong – Jay Harrison
+852 2852 6337

London - Donna Ward
+44 (20) 7007 0902

Madrid – Manuel Arranz
+34 (91) 514 5072

Mexico City – James Primus
+52 (55) 5080 6781

Paris – Don Andrade
+33 (1) 4088 2508

Sao Paulo – Ed Ruiz
+55 (11) 5185 2500

Tokyo – Paul Thurston
+81 (3) 6213 3159

Toronto - Rod Barr
+1 (416) 874 3630

Deloitte periodically publishes Accounting Roundups and Heads Ups. Click here to access the published ones.

GAAP Matters

Recent EITF Meeting

The Emerging Issues Task Force (EITF) met on March 17, 2005 and reached consensus on Issue No. 04-6, *Accounting for Post-Production Stripping Costs in the Mining Industry*.

This EITF consensus was ratified by the Financial Accounting Standards Board (FASB) at its March 30, 2005 meeting.

The Task Force also discussed the following issues without reaching a consensus:

- Issue No. 04-5, *Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights*
- Issue No. 04-7, *Determining Whether an Interest Is a Variable Interest in a Variable Interest Entity*
- Issue No. 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty*
- Issue No. 05-1, *The Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuers Exercise of a Call Option that Otherwise Is Not Convertible or Not Currently Convertible Based on a Contingency*

In addition, the Task Force removed from the agenda Issue 04-7, *Determining Whether an Interest Is a Variable Interest in a Variable Interest Entity* and recommended that the FASB should address this issue in a separate project.

Click here for the full text of the March EITF roundup and click here for the full text of the minutes of the EITF meeting.

Consensus on EITF Issue No. 04-6, Accounting for Post-Production Stripping Costs in the Mining Industry

Mining companies incur costs to remove overburden and other mine waste material (referred to as stripping costs) in order to access mineral deposits. During the development stage of a mine (before production begins), these costs are capitalized as part of the cost of the mine and frequently are amortized over the productive life of the mine using the units of production method.

Once production begins, should ongoing stripping costs be expensed or capitalized? Conceptually, stripping costs may benefit both current period production (because removal of the waste is necessary to extract the material mined in the current period), as well as future periods (because the costs facilitate access to additional minerals to be mined in the future). Currently, most mining companies expense

As used in this document, the term “Deloitte” includes Deloitte & Touche LLP, Deloitte Consulting LLP, and subsidiaries.

stripping costs as incurred or capitalize and attribute the costs based on a "life of mine stripping ratio."

At previous meetings, the Task Force reached a tentative conclusion that stripping costs incurred during production are mine development costs that should be capitalized as an investment in the mine. Further, the costs should be attributed to proved and probable reserves in a systematic and rational manner.

At the March meeting, the Task Force reversed its previous conclusions; it reached a consensus that stripping costs incurred during production are **variable production costs** that should be considered a **component of inventory** in each period. That is, production stripping costs incurred in a given period should be associated with the activities of that period, without consideration of future potential benefits. For mining companies that keep relatively little mineral inventory on hand at the end of a financial reporting period, the consensus effectively requires them to expense the bulk of each period's stripping costs, because only a minor amount of current period stripping costs will be associated with period-end inventory.

This guidance is effective for financial statements issued for fiscal years beginning after December 15, 2005, with early adoption permitted. Entities will recognize the cumulative effect of initially applying this consensus in a manner similar to APB Opinion No. 20, *Accounting Changes* (pro-forma disclosures of the effect on previous financial statements would not be required).

Restatement of previously issued financial statements is permitted.

Click here to access the March EITF Roundup and click here to access the full text of the EITF Meeting Minutes on Issue No. 04-6.

FASB issues FSP FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46 (R)*

On March 3, 2005, the FASB issued FSP FIN 46(R)-5, Implicit Variable Interests under FASB Interpretation No. 46 (R), Consolidation of Variable Interest Entities. The FSP attempts to provide more guidance for the term *implicit variable interests.*

The FSP requires a reporting enterprise to consider whether it holds an implicit variable interest in the VIE or potential VIE. The determination of whether an implicit variable interest exists involves determining whether an enterprise may be indirectly absorbing or receiving the variability of the entity.

An ***explicit*** variable interest results from a contract or arrangement between a reporting enterprise and a potential variable interest entity (VIE) that changes with changes in the fair value of the entity's net assets. In other words, the arrangement directly absorbs or receives all or part of the variability of the potential VIE.

An ***implicit*** variable interest exactly is like an explicit variable interest - except that it does not arise via a contract with a potential VIE. Instead, for the purposes of the FSP, the implicit variable interest "exists" by virtue of an understanding between an enterprise that holds an explicit variable interest and a reporting enterprise. Read more on the topic below.

The guidance in this FSP shall be applied in the first reporting period beginning after March 3, 2005. Click here for the full text of the FSP.

FASB issues FSP EITF 85-24-1, Application of EITF Issue No. 85-24, "Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge," When Cash for the Right to Future Distribution Fees for Shares Previously Sold Is Received from Third Parties

On March 11, 2005, the FASB staff issued this FSP in response to questions that have arisen around the appropriate accounting for cash received from a third party for a distributor's right to future cash flows relating to distribution fees for shares previously sold. The FSP states that revenue recognition is appropriate when cash is received from a third party for the Rights (this FSP refers to 12b-1 fees and contingent deferred sales charges for shares previously sold collectively as "Rights") if the distributor has neither continuing involvement with the Rights nor recourse. These conditions are met when neither the distributor nor any member of the consolidated group that includes the distributor (1) retains any disproportionate risks or rewards in the cash flows of the Rights that are sold, (2) guarantees or assures in any way the purchaser's rate of return on the investment in the related Rights, or (3) contractually restricts the ability of the consolidated group or the mutual fund independent board to remove, replace, or subcontract any of the service providers of the fund. Deferred costs for the shares sold to which the Rights pertain should be expensed concurrent with the recognition of revenue consistent with the requirements of Issue 85-24. The FSP also requires the distributor to disclose the amount of revenue recognized and the related amount of deferred costs that have been expensed in each period in which the distributor receives cash from a third party for the Rights.

The guidance in this FSP is effective for reporting periods beginning after March 11, 2005. Click here for the full text of the FSP.

FASB Revises Statement 133 Implementation Issues

In connection with the issuance of FASB Statement No. 123(R), Share-Based Payment, the FASB has revised guidance related to the following Statement 133 Implementation Issues:

- No. C3, "Scope Exceptions: Exception Related to Share-Based Payment Arrangements" – Implementation Issue C3 originally clarified that the scope exception for contracts issued in connection with stock-based compensation arrangements within paragraph 11(b) of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, applied to equity instruments granted to nonemployees as compensation for goods and services. The revisions to Implementation Issue C3 limit the scope exception only to those share-based payment contracts with nonemployees that are subject to Statement 123(R). Therefore, a contract no longer qualifies for the scope exception and may need to be accounted for as a derivative under Statement 133 once the performance related to the transaction has occurred.
- No. E19, "Hedging – General: Methods of Assessing Hedge Effectiveness When Options Are Designated as the Hedging Instrument" – Implementation Issue E19 provides guidance on assessing hedge effectiveness in hedging relationships that involve an option contract designated as the hedging instrument. The revisions to Implementation Issue E19 consist of updating the references within the guidance to Statement 123(R) without substantive changes to the existing accounting guidance.
- No. G1, "Cash Flow Hedges: Hedging and SAR Obligation" – Implementation Issue G1 provides guidance for hedging unrecognized, non-vested, stock appreciation rights (SARs). Under Statement 123(R), public companies are required to remeasure SARs at fair value each reporting period until the date of settlement. In contrast, Statement 123 required companies to remeasure SARs at intrinsic value. The revised Implementation Issue G1 will continue to allow entities to enter into cash flow hedges of the exposure to variability in expected future cash flows associated with SARs; however, hedge effectiveness will typically be assessed based on changes in the entire fair value of the purchased option instead of based on the changes in the intrinsic

As used in this document, the term "Deloitte" includes Deloitte & Touche LLP, Deloitte Consulting LLP, and subsidiaries.

continued on next page.

value of the purchased option. Implementation Issue G1 is also being revised to clarify that this Issue applies to public companies.

The effective date of these revisions is the beginning of the period in which the entity initially adopts Statement 123(R). Click here to access the full text of the implementation issues.

SEC and Other Regulatory Matters

SEC Extends Compliance Dates for Non-Accelerated Filers And Foreign Private Issuers Regarding Internal Control Over Financial Reporting Requirements

On March 2, 2005, the U.S. Securities and Exchange Commission (SEC) has further extended the compliance dates for non-accelerated filers and foreign private issuers (FPIs) regarding amendments to its rules under the Securities Exchange Act of 1934 that were adopted on June 5, 2003, pursuant to Section 404 of the Sarbanes-Oxley Act. The amendments require a company to include in its annual reports a report by management on the company's internal control over financial reporting and an accompanying auditor's report.

Under this extension, a company that is not required to file its annual and quarterly reports on an accelerated basis (non-accelerated filer) and a FPI filing its annual reports on Form 20-F or 40-F, must begin to comply with the internal control over financial reporting requirements for its first fiscal year ending on or after July 15, 2006. This is a one-year extension from the previously established July 15, 2005, compliance date for non-accelerated filers and FPIs. The SEC considered the particular challenges facing non-accelerated filers and FPIs in deciding to grant this extension. Many foreign companies are facing regulatory and reporting challenges in addition to internal control reporting as companies incorporated in a European Union member country are required to prepare their financial statements for 2005 in accordance with International Financial Reporting Standards.

Click here for full text of the SEC release.

Clarification of the Extension of Compliance Dates for Non-Accelerated Filers And Foreign Private Issuers Regarding Internal Control Over Financial Reporting Requirements

The application of this rule depends on whether a company meets the definition of an accelerated filer, as defined in Exchange Act Rule 12b-2, at November 15, 2004. If it does, the company is required to comply with Section 404 of the Sarbanes-Oxley Act beginning with its first fiscal year ending on or after November 15, 2004. FPIs are not accelerated filers; therefore, they are required to comply with Section 404 beginning with their first fiscal year ending on or after July 15, 2006. In addition, debt-only issuers are not accelerated filers, because they have no market capitalization; therefore, they have to comply with Section 404 beginning with their first fiscal year ending on or after July 15, 2006. Questions arise when a filer obtains the accelerated filer status after November 15, 2004 but prior to July 15, 2006. There are several scenarios that illustrate how the extension of the compliance dates for Section 404 will affect these companies -Read more on this below.

SEC Issues Sample Letter Related to the Statement of Cash Flow

On February 15, 2005, the staff of the SEC Division of Corporation Finance issued a sample of a letter of comment that is being issued broadly to various registrants and could affect reporting by calendar year-end companies. In this letter, the SEC staff reminded registrants that FASB Statement No. 95, Statement of Cash Flows, provides that cash receipts from sales of goods or services are operating cash flows. The staff indicated that this classification is required regardless of whether those cash flows result from the collection of the receivable from the customer or the sale of the receivable to others. The staff noted that the basis for conclusions in Statement 95 indicates that the FASB considered and rejected classifying any portion of the cash receipts from the sale of inventory as investing activities. The staff indicated that misclassification of cash receipts from inventory as financing within the consolidated statements of cash flows does not comply with Statement 95. If a registrant corrects the classification of such a cash flow, the staff indicated that it will not object to registrants providing disclosures that do **not** specifically reference the correction of an error provided the company makes the disclosures outlined in the letter. Click here for the full text of the letter.

SEC Issues Sample Letter Related to Buy/Sell Arrangements and Other Issues in the Oil and Gas Industry

On February 15, 2005, the staff of the SEC Division of Corporation Finance also issued a sample of a letter of comment to registrants engaged in Oil and Gas operations. The letter discusses the following issues:

- Buy/Sell transactions for commodities that are utilized in the petroleum industry and other industries. The EITF, in issue No. 04-13, Accounting for Purchases and Sales of Inventory with the Same Counterparty, is considering whether these transactions should be recorded at cost. In addition, the SEC questions whether they should be recorded on a gross basis. Therefore, companies engaging in buy-sell or comparable transactions should provide the disclosures specified in the letter in their filings that include financial reports covering periods ending on or after December 15, 2004.
- Capitalized exploratory drilling costs. All registrants engaged in oil and gas exploration and production activities that follow the successful efforts method of accounting should provide the disclosures specified in the letter with respect to capitalized exploratory drilling costs pending the determination of proved reserves in filings that include financial reports covering periods ending on or after December 15, 2004.
- Disposition of oil and gas properties. All registrants engaged in oil and gas exploration and production activities that follow the full cost method of accounting should apply the guidance for all periods with respect to dispositions of oil and gas properties involving less than 25% of the reserve quantities of a given cost center.

Click here for the full text of the letter.

SEC Staff Clarifies Lease Accounting Issues

On February 7, 2005, the SEC staff issued a letter to the Center for Public Company Audit Firms to clarify its views on the following leasing issues:

Amortization of Leasehold Improvements – The SEC staff is of the view that amortizing leasehold improvements over a term that includes assumption of lease renewals is appropriate only when the renewals have been determined to be **reasonably assured**, as that term is used in FASB Statement No. 13, *Accounting for Leases*. A lessee under an operating lease should amortize leasehold improvements over the shorter of their economic lives or the lease term.

As used in this document, the term "Deloitte" includes Deloitte & Touche LLP, Deloitte Consulting LLP, and subsidiaries.

continued on next page.

Rent Holidays - The SEC staff concluded that it is inappropriate for a lessee to suspend recognition of rental expense during a rent holiday.

Landlord/Tenant Incentives – Occasionally, a landlord under an operating lease pays the lessee an amount intended to reimburse the lessee for the cost, or a portion of the cost, of leasehold improvements. Click here to access the full text of the letter. Click here to access Deloitte's Heads Up on the topic.

Read more on this issue below.

Lessor Accounting Issues

As discussed above, on February 7, 2005, Donald T. Nicolaisen, Chief Accountant of the SEC, issued a letter to the Center for Public Company Audit Firms providing the SEC staff's views on certain lease accounting issues. In addition, Deloitte issued a "Heads Up" document discussing these issues. Both documents concentrated primarily on the accounting for these issues by the lessees. Here we focus on the same issues from the standpoint of ***lessors***, namely:

- Lessor funding of lessee expenditures (e.g., funding of tenant improvements),
- Accounting for rent holidays, and
- Other items, including key provisions of FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects.

Read more on this topic below.

Capitalization of Rent during a Construction Period

A recent *Heads Up* (see above) discussed the accounting by lessees for operating leases including the accounting for rent holidays. Based upon recent discussions with the SEC staff, there are two acceptable methods to account for rent costs recognized during the period of time a lessee is performing build-out or construction activities. The first method is to expense rent costs in the period they are recognized (the "Expense Method"). The second method is to capitalize rent costs recognized during a construction period as a cost of the constructed asset (the "Capitalization Method"). The SEC staff believes if a registrant previously had not established an accounting policy with respect to rents recognized during a construction period, then it would be acceptable to adopt either method of accounting for those rent costs. Read more on this below.

SEC Updates the International Reporting and Disclosure Issues Outline

On February 24, 2005, the SEC released the most recent update of the International Reporting and Disclosure Issues, which is dated November 1, 2004. New or substantially expanded material is primarily located in the following Sections of the Outline:

II. Recent Commission Actions

III.D Audit Report Reference to Compliance with GAAS

IV.C Quality of Audits and Reconciliations to US GAAP

V.A Audit Report Signature Requirements

V.J References to Another Auditor

VI. Issues Encountered in Reconciliations to US GAAP - Items A, B, and C

X. Other Disclosure Issues - Items A, H, and I

Also, various pre-existing items that address the financial statements of entities other than the registrant, have been reorganized into new Section IX "Financial Statements of Other Entities".

Click here for the full text of the outline.

SEC Issues Staff Alert with Annual Report Reminders

This Alert, issued on March 4, 2005, from the staff of the Division of Corporation Finance is designed to remind some companies of a few points in completing their annual reports on Forms 10-K and 10-KSB. The staff of the Division of Corporation Finance has observed or has become aware of some common issues arising in this annual report filing season. Specific to FPIs, it states that they may continue to omit the Section 404 language from their certifications (in accordance with the transition provisions) until they are required to file their first internal control reports. The SEC draws attention to the following points:

- Disclosure of Previously Unreported Form 8-K Events
- Correct Version of the Certifications Required by Rules 13a-14(a) and 15d-14(a)
- Placement of the Internal Control Reports
- Auditor Consents

Click here to access the full text of the alert.

SEC Updates EDGAR Filer Manual and Adopts XBRL Voluntary Financial Reporting Program

On February 7, 2005, the SEC adopted revisions to the Electronic Data Gathering, Analysis, and Retrieval system (EDGAR) Filer Manual to reflect updates to the EDGAR system. The revisions are being made to enable registrants to submit tagged financial information using the eXtensible Business Reporting Language (XBRL) format as exhibits to specified EDGAR filings under the Securities Exchange Act of 1934 and the Investment Company Act of 1940. Registrants choosing to participate in the voluntary program also will continue to file their financial information currently under required formats.

The voluntary program, intended to assist in the evaluation of the usefulness of data tagging and XBRL, became effective March 16, 2005. The related rules are available on the SEC's Web site.

Click here to access the full text of the SEC release.

SEC Issues Letters Regarding Auditing Standards for Financial Statements of Insurance Company Depositors of Variable Insurance Products

On March 8, 2005, the SEC Division of Investment Management issued letters, in which it clarified the auditing standards required for certain insurance companies. Financial statements of insurance company depositors that are, in their own right, Exchange Act filers, including mutual insurance companies that issue registered market value adjustment contracts, must be audited in accordance with PCAOB standards. In addition, the financial statements of registered separate accounts that issue variable insurance contracts must be audited in accordance with PCAOB standards.

The staff of the Commission also noted that it will not object if certain insurance company depositor or sponsor (hereinafter, "depositor") financial statements included in the registration statements of variable annuity and variable life insurance contracts are audited in accordance with either the auditing standards of the Public Company Accounting Oversight Board ("PCAOB") or generally accepted auditing standards issued by the American Institute of Certified Public Accountants' (AICPA's) Auditing Standards Board ("GAAS"). This applies only to certain companies that are registered as investment companies under the Investment Company Act of 1940 and that are only connected to the Securities Exchange Act of 1934 ("Exchange Act") as depositors of

As used in this document, the term "Deloitte" includes Deloitte & Touche LLP, Deloitte Consulting LLP, and subsidiaries.

continued on next page.

one or more separate accounts that issue variable insurance contracts. Click here for the full text of the letters.

NYSE Issues Corporate Governance Letter to Foreign Private Issuers

On February 9, 2005, the New York Stock Exchange (NYSE) issued a letter to FPIs listed on the NYSE to provide guidelines as to their obligations regarding notifications sent to the NYSE, and other filing requirements. Specifically, in addition to the notifications to the NYSE, the letter includes a summary of the annual report requirements, filings with the exchange, corporate governance requirements, transactions requiring supplemental listing applications, stock certificate policy reminder, and NYSE timely alert policy reminder.

Click here to access the full text of the letter.

Miscellaneous

AICPA Issues Technical Practice Aids (TPAs) Related to "Accounting by Noninsurance Enterprises for Property and Casualty Insurance Arrangements That Limit Insurance Risk"

In February 2005, the AICPA issued a series of TPAs focusing on certain aspects of finite insurance products utilized by nonisurance enterprises. These TPAs have been designed to assist practitioners in identifying the relevant literature to consider in addressing their specific facts and circumstances.

Although the TPAs contain many excerpts of applicable guidance, readers should familiarize themselves with all of the relevant literature. The guidance in these TPAs addresses property and casualty insurance contracts between a policyholder and an insurance enterprise, which is similar to the relationship between an insurer and a reinsurer. Click here to access the TPA.

Deloitte Issues SEC Compliance Checklist and Checklist for Annual Report on SEC Form 20-F

Deloitte & Touche LLP issues an SEC Compliance Checklist and the Checklist for Annual Report on SEC Form 20-F. These checklists are not to be considered all-inclusive and are not a substitute for understanding the disclosure and filing requirements of the SEC. Clients and others are presumed to have a thorough understanding of the rules, regulations, and interpretations of the SEC and its staff and should refer to those rules, regulations, and interpretations, as necessary, in considering particular items in the checklist.

Click here to access the SEC checklist and click here to access the Form 20-F checklist internally. Both checklists are appropriate for external distribution, including auditing clients. To obtain a copy of the checklist externally please contact a Deloitte professional.

Deloitte Issues Whitepaper: *Sarbanes-Oxley 404: Compliance Challenges for Foreign Private Issuers*

In the United States, public companies large and small have labored over the requirements of section 404 of the Sarbanes-Oxley Act. Especially demanding has been the burden on companies with international operations, which are required to assess internal control over financial reporting in locations outside of the United States. FPIs are required to include in their annual report, beginning with year-ends on or after July 15, 2006, management's assessment of internal control over financial reporting. In light of the SEC's most recent delay of the effective date of section 404, Deloitte highly recommends that FPIs do not change the timing or scope of their section 404 work.

This document, entitled *Sarbanes-Oxley Section 404: Compliance Challenges for Foreign Private Issuers*, summarizes the experiences of these companies and highlights key challenges that many FPIs will face as part of their section 404 readiness activities.

Click here to access the whitepaper internally. To obtain a copy of the whitepaper externally please contact a Deloitte professional.

FEI's Top Ten Financial Reporting Issues for 2005

Financial Executives International (FEI) recently released a list of 10 prominent financial reporting issues that require special attention of financial executives in 2005. The list includes the following matters:

- Stock options
- Internal controls
- Revenue recognition
- Uncertain tax positions
- Unremitted foreign earnings
- Business combinations
- Inventory costs
- Off-balance sheet arrangements disclosures
- XBRL
- MD&A guidance

Click here to access the FEI publication. To assist financial executives and audit committees in addressing these issues, Deloitte & Touche LLP prepared a special edition of the Audit Committee Brief, "*FEI's Top 10 Financial Reporting Issues for 2005: Deloitte & Touche Resources for Addressing These Issues*," which includes Deloitte & Touche and other resources relevant to each topic. Click here to access the Audit Committee Brief, which is published on Deloitte's Audit Committee Online or contact a Deloitte professional.

Investors, the Stock Market, and Sarbanes-Oxley's New Section 404 Requirements

Stanford Law School, co-sponsored by Big Four accounting firms, hosted an investor symposium to provide investors with an opportunity to learn about the operation of Section 404 of the Sarbanes-Oxley Act and its potential implications for stock market pricing, corporate policy, and for the audit process. The key themes discussed include:

- Section 404 is not a one-time event.
- Companies should strive to complete their assessments on time, even if the result is an adverse opinion.
- Significant judgment is involved in evaluating control deficiencies.
- Not all material weaknesses are the same.
- The capital markets are "smart." If management's disclosure is transparent, investors will react appropriately to material weaknesses.
- Some companies may be more susceptible to material weaknesses. Some material weaknesses may be more common than others.
- A company can receive a "clean" financial statement opinion yet still have ineffective internal control.
- Investors should avoid a "false perception" that the new Section 404 internal control reporting makes financial statements more precise.
- Further analysis is needed to understand the relationship between costs to companies and benefits to investors and to the capital markets.

As used in this document, the term "Deloitte" includes Deloitte & Touche LLP, Deloitte Consulting LLP, and subsidiaries.

continued on next page.

Click here to access the full text of the publication.

Recent Deloitte Publications

Below is a list of Deloitte publications about the most recent rule proposals and legislative actions.

Accounting Roundup: March 31, 2005

EITF Roundup: March, 2005

Accounting Roundup: February 28, 2005

Accounting Roundup: January 31, 2005

Heads Up: Vol. 12, Issue 1. "It's Official, 13 is Unlucky! SEC Clarification of Statement 13 Lease Accounting Issues Leads to Restatements."

Audit Committee Brief: February 2005.

Disarming the Value Killers

Deloitte & Touche LLP and Deloitte Research analyzed the possible causes of major loss of share value experienced by hundreds of the largest international companies over the last ten years. Some of the results were expected, such as the major negative impact of the September 11, 2001 terrorist attacks. Yet other results yielded some surprises, which have been compiled in this whitepaper. The research found that risks may lurk in unexpected places, and that certain events can have such devastating effects that many organizations never recover from the losses. In the paper, Deloitte identifies which factors potentially became "value killers" and explains what might be done to address such threats. To obtain a copy of the whitepaper externally please contact a Deloitte professional.

2005 Global Industry Outlooks

The 2005 Global Industry Outlooks provide an overview of the 'Top 10' key issues currently facing companies in each of the industries. As in previous years, each report presents the Deloitte 'point-of-view' on sector-specific issues, drawing on a wide range of research and commentary from industry figures. The following Global Industry Outlooks are available:

2005 Global Financial Services Industry Outlook
2005 Global Insurance Industry Outlook
2005 Global Asset Management Industry Outlook
2005 Global Banking Industry Outlook
2005 Global Securities Industry Outlook
To obtain a copy of the publications externally please contact a Deloitte professional.

TMT Trends: Predictions 2005

The predictions address the following questions: What's going to happen in the TMT industry in 2005? How is music downloading going to progress? What will broadband do? How will advertising evolve? What will be the impact of convergence? How will companies need to prepare for digital security? The publications address four different sectors – Technology, Media, Mobile & Wireless, and Wireline. To obtain a copy of the publications externally please contact a Deloitte professional.

Under Control, Guidance for Sustaining Compliance with Sarbanes-Oxley Section 404

This publication is created for accelerated filers who have completed (or nearly completed) year-one work. Based on the Sustained Compliance Solution Framework, it draws heavily on Deloitte's field experience with over 1,000 Sarbanes-Oxley related engagements and discusses essential characteristics of sustainability and analyzes critical shortcomings that many companies experienced in their first-year efforts.

A Framework for Evaluating Control Exceptions and Deficiencies

See discussion "A Framework for Evaluating Control Exceptions and Deficiencies" above

Accounting Roundup 4th Quarter in Review - 2004

2005 Global Powers of Retailing

This report identifies the 250 largest retailers around the world and provides economic, demographic and industry insights on trends in the global marketplace. The report also contains an analysis of retail stock performance and a discussion of the major issues facing retailers today.

Useful Resources for Non-U.S. Companies Offering Securities

Heads Up: Vol. 11 Issue 10. "1•2•3(R)eady, Set, Go Fair Value Accounting for Stock Options!"

Heads Up: Vol.11, Issue 9. Accounting Highlights of the AICPA's December 6-8, 2004 SEC & PCAOB Conference

Heads Up: Vol. 11, Issue 8. "Well, Isn't That Special? FASB Staff Proposes Accounting Guidance in Response to the New Tax Act"

Heads Up: Vol.11, Issue 7. "Bringing Home the Bacon! New Tax Act Stimulates Repatriation of Earnings, Offers Tax Breaks to U.S. Manufacturers"

IAS Plus Website -

The International Accounting Standards Board recently revised several pronouncements, such as IAS 1, 2, 3, 8, 10, 16, 17, 24, 28, 32, 33, 39 and 40. Deloitte's IAS Plus website discusses these revisions as well as other current and future developments in the International Financial Reporting Standards (IFRS) environment.

E-learning training materials for International Financial Reporting Standards

Deloitte is pleased to make available e-learning training materials for IFRS free of charge. Click here to Access Deloitte's IFRS e-Learning Material. Content on the following standards is now available: IAS 1, IAS 2, IAS 7, IAS 8, IAS 10, IAS 11, IAS 14, IAS 16, IAS 17, IAS 18, IAS 21, IAS 27, IAS 28, IAS 31, IAS 34, IAS 37, IAS 40, IAS 41, and the Framework for the Preparation and Presentation of Financial Statements. Modules on the remaining standards are currently being developed and will be released in phases throughout 2004.

Other useful publications can be obtained on Deloitte's website – Click here

As used in this document, the term "Deloitte" includes Deloitte & Touche LLP, Deloitte Consulting LLP, and subsidiaries.

continued on next page.

Back to top

* * *

As used in this document, the term "Deloitte" includes Deloitte & Touche LLP, Deloitte Consulting LLP, and subsidiaries.

continued on next page.

GAAP Matters

FASB issues FSP FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46 (R)*

The FSP FIN 46(R)-5 clarifies that companies need to identify their holdings of *implicit variable interests* when applying Interpretation 46(R). Although *implicit variable interests* are mentioned in the Interpretation, the term is not defined and it only provides a single example (paragraph B10). The FSP is designed to shed more light on the topic.

Example – Enterprises A and B are voting interest entities (i.e., not VIEs). Except for the arrangements described in this example, A, B and VIE X are unrelated parties under Statement 57 and FIN 46(R).

Enterprise A owns a variable interest in VIE X, and enters into an agreement with B. The value of the agreement changes with changes in the fair value of the net assets of VIE X.

The FSP does **not** establish whether B holds an implicit variable interest in this fact pattern. Instead, according to the FSP, B must consider whether or not its arrangement with A is an implicit variable interest in VIE X.

How does B go about deciding whether its contract with A is an implicit variable interest in VIE X? According to the FSP, there is a need to apply judgment and consider relevant facts and circumstances.

The FSP provides a specific example as follows (encountered in practice, often in the context of non-public companies) when it is necessary to consider whether an implicit variable interest exists, as well as some of the relevant facts and circumstances to make the determination:

> One of the two owners of Manufacturing Company is also the sole owner of Leasing Company, which is a VIE. The owner of Leasing Company provides a guarantee of Leasing Company's debt as required by the lender. Leasing Company owns no assets other than the manufacturing facility being leased to Manufacturing Company. The lease, with market terms, contains no explicit guarantees of the residual value of the real estate or purchase options and is therefore not considered a variable interest under paragraph B24 of Interpretation 46(R). The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Company and Leasing Company.
>
> Although the lease agreement itself does not contain a contractual guarantee, Manufacturing Company should consider whether it holds an implicit variable interest in Leasing Company as a result of the leasing arrangement and the relationship between it and the owner of Leasing Company. For example, Manufacturing Company would be considered to hold an implicit variable interest in Leasing Company if Manufacturing Company effectively guaranteed the owner's investment in Leasing Company. [Footnote omitted] Manufacturing Company may be expected to make funds available to Leasing Company to prevent the owner's guarantee of Leasing Company's debt from being called on, or Manufacturing Company may be expected to make funds available to the owner to fund all or a portion of the call on Leasing Company's debt guarantee.

The relevant facts and circumstances to consider include, but are not limited to:

- Whether there is an economic incentive for Manufacturing Company to act as a guarantor or to make funds available,
- Whether such actions have happened in similar situations in the past, and
- Whether Manufacturing Company acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

The FASB staff notes that the issue commonly arises in leasing arrangements among related parties (as illustrated in the example above). But the FSP casts a broader net.

- First, the issue can arise in a context other than leasing arrangements (the FSP mentions supply contracts, service contracts, and derivatives).
- Second, it can arise in arrangements between two enterprises that are not otherwise related parties.

Companies should consider the documentation necessary to support their conclusions when the FSP requires them to consider whether an arrangement is an implicit variable interest.

Back to top

SEC and Other Regulatory Matters

Clarification of the Extension of Compliance Dates for Non-Accelerated Filers And Foreign Private Issuers Regarding Internal Control Over Financial Reporting Requirements

Any issuer (except for investment companies registered under Section 8 of the Investment Company Act of 1940) that meets the definition of an accelerated filer after November 15, 2004 but prior to July 15, 2006 is required to comply with Section 404 of the Sarbanes-Oxley Act beginning with that fiscal year. Note that accelerated filer status is reassessed each year; therefore:

- A nonaccelerated filer may become an accelerated filer prior to July 15, 2006 and, thus, would be subject to Section 404 beginning with the fiscal year in which it was first considered to be an accelerated filer.
- For example, a nonaccelerated filer at December 31, 2004 would reassess its status for the fiscal year ending December 31, 2005. If it is considered to be an accelerated filer at December 31, 2005, the company would first have to comply with Section 404 for its fiscal year ended December 31, 2005. If it is not considered to be an accelerated filer at December 31, 2005, it would have to comply with Section 404 for its fiscal year ended December 31, 2006 (its first year end after July 15, 2006).
- A nonissuer equity initial public offering (IPO) that becomes effective prior to July 14, 2005 may be considered to be an accelerated filer prior to July 15, 2006 and, if so, would be required to comply with Section 404 earlier than July 15, 2006.
- For example, a privately-held company with a December 31 fiscal year end completed an equity IPO in November 2004. It would not be considered to be an accelerated filer at December 31, 2004. However, provided its market capitalization at June 30, 2005 exceeds $75 million, it would be considered to be an accelerated filer at December 31, 2005. Thus, the company would have to comply with Section 404 for its fiscal year ended December 31, 2005.
- A nonissuer debt and/or equity IPO that becomes effective after July 15, 2005 would not be considered to be an accelerated filer prior to July 15, 2006 due to the requirement that the company has to have been subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 for at least 12 calendar months to be considered an accelerated filer. Such

As used in this document, the term "Deloitte" includes Deloitte & Touche LLP, Deloitte Consulting LLP, and subsidiaries.

continued on next page.

companies would have to comply with Section 404 beginning with their first fiscal year ending on or after July 15, 2006.

- For example, a privately held company with a December 31 fiscal year end completes a debt or equity IPO in August 2005. It would not be considered to be an accelerated filer at December 31, 2005, because it was not subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 for at least 12 calendar months. It would therefore first comply with Section 404 for its fiscal year ended December 31, 2006.
- A debt-only issuer that completes an equity IPO may become an accelerated filer in the year of the equity IPO if it has been an issuer subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 for at least 12 calendar months.

For example, a debt-only issuer with a December 31 fiscal year end completes an equity IPO in May 2005 (its debt had been issued prior to December 31, 2004). If its market capitalization at June 30, 2005 exceeds $75 million, it would be considered to be an accelerated filer at December 31, 2005, because it was already subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 for at least 12 calendar months at December 31, 2005. It would therefore first comply with Section 404 for the fiscal year December 31, 2005.

All issuers (except for investment companies registered under Section 8 of the Investment Company Act of 1940) are required to comply with Sarbanes-Oxley Act Section 404 for fiscal years ending on or after July 15, 2006 (i.e., the accelerated filer rules are no longer relevant for Section 404 purposes). This would include:

- Accelerated filers
- Nonaccelerated filers, including debt-only issuers and FPIs
- Debt-only and equity IPOs beginning with their first annual report following their IPO, regardless of whether they have been subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 for at least 12 calendar months.

Back to top

SEC Staff Clarifies Lease Accounting Issues

In its February 7, 2005 letter, the SEC addressed certain lease accounting issues. In addition to the issue of amortization of leasehold improvements, the SEC discussed the following:

Rent Holidays - The SEC staff, pointing to FASB Technical Bulletin No. 85-3, *Accounting for Operating Leases With Scheduled Rent Increases*, concluded that it is inappropriate for a lessee to suspend recognition of rental expense during a rent holiday. Rather, rent expense in an operating lease should be recognized straight-line over the lease term, including any rent holiday period, unless another systematic and rational allocation is more representative of the lease property's anticipated use.

Landlord/Tenant Incentives – Occasionally, a landlord under an operating lease pays the lessee an amount intended to reimburse the lessee for the cost, or a portion of the cost, of leasehold improvements. The SEC staff has the following views on the accounting for such transactions:

- The incentives received should be recorded as deferred rent and amortized as reductions to lease expense over the lease term in accordance with paragraph 15 of Statement 13 and FASB Technical Bulleting No. 88-1, Issues Relating to Accounting for Leases (the deferred rent should not be netted against leasehold improvements); and
- The incentive payment receipt should be presented as an operating activity in the lessee's statement of cash flows. The acquisition of leasehold improvements for cash should be classified as an investing activity. The SEC staff also recognizes that determining whether improvements are assets of the lessee or the lessor may require significant judgment; the letter does not deal with this evaluation. The SEC staff indicated that its views are based upon existing accounting literature. Registrants/lessees who determine that they have made one or more of these errors, in consultation with their independent auditors, should follow one of two courses of action, as appropriate:
  - Restate prior financial statements, and disclose that the restatement results from the correction of errors; or
  - If restatement was determined by management to be unnecessary, state that the errors were immaterial to prior periods.

The SEC staff's letter also highlights the importance of providing clear and concise operating and capital lease disclosures in the notes to the financial statements and, when appropriate, in the critical accounting policies section of Management's Discussion and Analysis. Click here to access the full text of the letter. Click here to access Deloitte's Heads Up on the topic.

Back to top

Lessor Accounting Issues

In connection with the February 7, 2005 SEC letter regarding certain lease accounting issues, the following discusses these issues from the standpoint of lessors:

Lessor Funding of Lessee Expenditures

The *Heads Up* and SEC staff letter addressed instances whereby a lessor provides a tenant allowance to the lessee including amounts designated for leasehold improvements. Lessor funding of lessee expenditures may be direct or indirect — cash paid directly to the lessee, cash paid to third parties on behalf of the lessee, etc. The appropriate accounting for the tenant allowance must be determined based upon the substance of the arrangement.

The determination of whether amounts payable under the lease are a lease incentive should be made based on contractual rights of the lessee and lessor. Lease incentives should be accounted for in accordance with FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*, paragraph 7, which states:

- Payments made to or on behalf of the lessee represent incentives that should be considered reductions of rental expense by the lessee and reductions of rental revenue by the lessor over the term of the new lease. Similarly, losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party should be considered an incentive by both the lessor and the lessee. Incentives should be recognized on a straight-line basis over the term of the new lease in accordance with paragraph 15 of Statement 13, Technical Bulletin 85-3, and paragraphs 1-5 above.

In his letter to the Center for Public Company Audit Firms, the Chief Accountant of the SEC also discussed the accounting for lease incentives as follows:

- Landlord/Tenant Incentives — The staff believes that: (a) leasehold improvements made by a lessee that are funded by landlord incentives or allowances under an operating lease should be recorded by the lessee as leasehold improvement assets and amortized over a term consistent with the guidance in item 1 above; (b) the incentives should be recorded as deferred rent and amortized as reductions to lease expense over the lease term in accordance with paragraph 15 of SFAS 13 and the response to

As used in this document, the term "Deloitte" includes Deloitte & Touche LLP, Deloitte Consulting LLP, and subsidiaries.

continued on next page.

Question 2 of FASB Technical Bulletin 88-1 (“FTB 88-1”), Issues Relating to Accounting for Leases, and therefore, the staff believes it is inappropriate to net the deferred rent against the leasehold improvements; and (c) a registrant's statement of cash flows should reflect cash received from the lessor that is accounted for as a lease incentive within operating activities and the acquisition of leasehold improvements for cash within investing activities. The staff recognizes that evaluating when improvements should be recorded as assets of the lessor or assets of the lessee may require significant judgment and factors in making that evaluation are not the subject of this letter.

The accounting for payments made by a landlord to, or on behalf of, a tenant to fund items that would be an expense or an obligation of the tenant, such as moving expenses or assumption of the tenant’s preexisting lease is clear under Technical Bulletin 88-1. However, the accounting for payments made by a landlord to a tenant related to tenant improvements is more complicated. In some situations, such payments may be lease incentives, which would be accounted for by the landlord as a lease incentive and amortized as a reduction of rental income over the lease term. In other situations, the landlord may be acquiring tangible assets (e.g., tenant improvements) to lease to the tenant, which would be accounted for as property, plant and equipment of the lessor and amortized to depreciation expense.

If, after considering the contractual terms of the arrangement and determining its substance, it is determined that the landlord is acquiring property (e.g., tenant improvements), which are property subject to lease, then it would be appropriate to account for such payments to the tenant as the acquisition of property. On the other hand, notwithstanding the designation of the payment as a tenant improvement allowance in the lease agreement, if it is determined that, in substance, the landlord is not acquiring property, such payments should be accounted for as lease incentives by the landlord.

Many lease agreements contain general provisions related to payments designated as funding tenant improvements. Such provisions may include the following:

- A provision that states that the intent of the payment is to fund tenant improvements;
- A provision that title to all tenant improvements transfers to the landlord as soon as they are installed;
- A provision that the tenant must provide proof of the release of mechanics liens prior to the payment being made; and
- A provision requiring the tenant to submit architectural drawings and construction plans to the landlord for approval prior to construction.

These provisions by themselves are not necessarily indicative of the substance and are not sufficient to conclude that the landlord is acquiring property from the tenant. For example, an agreement may specify that the allowance is intended to be used by the tenant to fund leasehold improvements, but not require that the tenant provide the landlord with proof of spending for tenant improvements as called for by the terms of the lease, or otherwise provide for a mechanism under which the landlord can monitor the usage of the tenant allowance. In such instances, normally, it should be presumed that the payment to the tenant represented a lease incentive and not the acquisition of property.

In other instances, the lease arrangement may require proof of expenditures on tenant improvements, but provide the tenant the right to retain or receive any allowance amounts that are excess of actual improvement costs. Ordinarily, it should be presumed that if a lease arrangement permits the tenant to retain this excess allowance as either cash or as a reduction of rent, that the substance is that all or a portion of the allowance is a lease incentive and not the acquisition of property.

If the tenant has discretion in the utilization of the funds received by the landlord (even if it is probable that such funds will be used to construct tenant improvements), this would be indicative of a presumption that the tenant improvements should be considered assets of the tenant for accounting purposes. If it is determined that, in substance, the tenant improvements are assets of the tenant, the landlord should treat the funding provided to the tenant as a lease incentive in accordance with Technical Bulletin 88-1.

Determining the substance of a lease arrangement that does not allow the tenant to retain the excess of landlord funding over actual improvement costs, nor grants the tenant discretion in how the allowance is spent, nor specifically identifies the leased property as not including the leasehold improvements, is more difficult and judgmental. Generally, the terms of a lease arrangement obligate the landlord to deliver the property subject to the lease while the terms associated with the construction of related leasehold improvements generally vary between lease arrangements. In some circumstances, a landlord may appropriately be considered to be the accounting owner of the leasehold improvements and therefore should not account for tenant allowances as a lease incentive. Factors to consider include, but are not limited to:

- Whether the tenant is obligated by the terms of the lease agreement to construct or install specifically identified assets (i.e., the leasehold improvements) as a condition of the lease;
- Whether the failure by the tenant to make specified improvements is an event of default under which the landlord can require the lessee to make those improvements or otherwise enforce the landlord’s rights to those assets (or a monetary equivalent);
- Whether the tenant is permitted to alter or remove the leasehold improvements without the consent of the landlord and/or without compensating the landlord for any lost utility or diminution in fair value;
- Whether the tenant is required to provide the landlord with evidence supporting the cost of tenant improvements prior to the landlord paying the tenant for the tenant improvements;
- Whether the landlord is obligated to fund cost overruns for the construction of leasehold improvements;
- Whether the leasehold improvements are unique to the tenant or could reasonably be used by the lessor to lease to other parties; and
- Whether the economic life of the leasehold improvements is such that it is anticipated that a significant residual value of the assets will accrue to the benefit of the landlord at the end of the lease term.

A careful evaluation of all factors for each lease must be undertaken; no one factor should be considered determinative.

Rent Holidays

An operating lease may contain a rent holiday (a period during which the lessee has the right to occupy the space, but has no obligation to make current rental payments) to, among other things, provide the lessee with time to build-out the space to its specifications. Paragraph 2 of Technical Bulletin 88-1 states that **both** lessees and lessors should recognize the minimum lease payments of a lease classified as an operating lease as follows:

If rents escalate in contemplation of the lessee's physical use of the leased property, including equipment, but the lessee takes possession of or controls the physical use of the property at the beginning of the lease term, all rental payments, including the escalated rents, should be recognized as rental expense or rental revenue on a straight-line

As used in this document, the term “Deloitte” includes Deloitte & Touche LLP, Deloitte Consulting LLP, and subsidiaries.

continued on next page.

basis in accordance with paragraph 15 of Statement 13 and Technical Bulletin 85-3 starting with the beginning of the lease term.

As such, it is not appropriate for a lessee to suspend recognition of rental expense during a rent holiday. **Rental expense or rental revenue should commence at the date the lessee takes possession of or controls the physical use of the leased asset.**

Accordingly, consistent with the above, if the lessee has the right to use the leased property for purposes of constructing improvements, it would be expected that the lessee will recognize rent expense and the lessor will recognize rent revenue as that period would be part of the lease term.

For illustration, consider the following example:

- A lease agreement between Company A (the "Landlord") and Company B (the "Tenant") provides that the lease starts on January 1, 2004, which also coincides with the date the Tenant's operations commence (e.g., date of store opening);
- Rental payments by the Tenant commence on January 1, 2004 in accordance with the terms of the lease agreement; and
- The Landlord completes construction of the property subject to the lease and allows the Tenant, in accordance with the lease agreement, to access the leased property on July 1, 2003 to construct improvements and to otherwise ready the property for the Tenant's intended use (i.e., a six-month build-out prior to the opening of the store).

In the example above, the Tenant has the right to use (and controls such use of) the leased property beginning July 1, 2003. Because, for accounting purposes, the lease has commenced on July 1, 2003, the Landlord should include the six-month build-out period in the lease term and recognize rental revenue starting on July 1, 2003 over the lease term (as defined in paragraph 5(f) of Statement 13), consistent with paragraph 2(a) of Technical Bulletin 88-1.

Consistent with the prior discussion of lessor funding of lessee expenditures, lessors will need to carefully evaluate and determine what property is the subject of the lease. If the leased property includes leasehold improvements (e.g., a turn-key facility), then, ordinarily, it would not be expected that the lease has commenced for accounting purposes until the property, inclusive of the leasehold improvements, is substantially complete.

Other

Lessors should also be mindful of other considerations and factors when evaluating the propriety of revenue recognition (e.g., SEC Staff Accounting Bulletin No. 104, *Revenue Recognition*), cost capitalization and the recognition of depreciation expense. For example, if the leased asset is not substantially complete when the tenant is granted the right to add leasehold improvements to the leased property, the landlord should also consider paragraphs 22 and 23 of FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, which state:

- When a real estate project is substantially completed and held available for occupancy, rental revenues and operating costs shall be recognized in income and expense as they accrue, all carrying costs (such as real estate taxes) shall be charged to expense when incurred, depreciation on the cost of the project shall be provided, and costs to rent the project shall be amortized in accordance with paragraph 21 of this Statement. A real estate project shall be considered substantially completed and held available for occupancy upon completion of tenant improvements by the developer but no later than one year from cessation of major construction activity (as distinguished from activities such as routine maintenance and cleanup).
- If portions of a rental project are substantially completed and occupied by tenants or held available for occupancy and other portions have not yet reached that stage, the substantially completed portions shall be accounted for as a separate project. Costs incurred shall be allocated between the portions under construction and the portions substantially completed and held available for occupancy.

Back to top

Capitalization of Rent during a Construction Period

As discussed above there was a heightened interest in recent *Heads Up* (Volume 12, Issue 1) discussed the accounting by lessees for operating leases including the accounting for rent holidays. A rent holiday is a period of time during which the lessee has the right to occupy the space but pays either no cash rent or pays a reduced rate of rent. For example, a lessee may be provided a rent-free period of time during which it is expected the lessee will build-out the leased space with improvements that are assets of the lessee. This rent-free period is a form of rent holiday. The SEC staff concluded that, based on FASB Technical Bulletin No. 85-3, *Accounting for Operating Leases With Scheduled Rent Increases*, it is inappropriate for a lessee to suspend recognition of rents during a rent holiday. Rather, rents in an operating lease should be recognized straight-line (or, unusually, on another systematic and rational basis) over the lease term, including any rent holiday period.

Based upon recent discussions with the SEC staff, there are two acceptable methods to account for rent costs recognized during the period of time a lessee is performing build-out or construction activities. The first method is to expense rent costs in the period they are recognized (the "Expense Method"). The second method is to capitalize rent costs recognized during a construction period as a cost of the constructed asset (the "Capitalization Method"). The SEC staff believes if a registrant previously had not established an accounting policy with respect to rents recognized during a construction period, then it would be acceptable to adopt either method of accounting for those rent costs. In other words, a company could adopt either the Expense Method or the Capitalization Method in the period it first recognizes rental costs during a construction period. The SEC staff based its conclusion on an analogy to FASB Statements No. 34, *Capitalization of Interest*, and 67, *Accounting for the Costs and Initial Rental Operations of Real Estate Projects*. Under the Capitalization Method, rental costs only should be capitalized during the construction period, and capitalization of such costs should cease when the leased premises are substantially ready for their intended use. By definition, if the premises are being used for "start-up" activities, such as for training or merchandising, as contemplated by AICPA Statement of Position 98-5, *Reporting on the Costs of Start-Up Activities*, the continued capitalization of rents would not be appropriate.

The SEC staff believes it is appropriate for a registrant that adopts an accounting policy to capitalize rents during a construction period to recognize the effects of that policy election in the period in which the registrant first recognizes construction period rents. That is, if construction period rents are being recognized for the first time as a result of correcting the registrant's determination of the lease term (i.e., via correction of an error), then it would be acceptable to adopt a policy to capitalize rental costs in the period(s) being restated. In such a situation, it would also be acceptable for a registrant to adopt the Expense Method in the period(s) being restated. Such an adoption is not considered a change in accounting policy, and, accordingly, a "preferability" letter is not required. Similarly, a company that previously has not adopted an accounting policy for such rent costs, and is evaluating the effects on prior period financial statements of

As used in this document, the term "Deloitte" includes Deloitte & Touche LLP, Deloitte Consulting LLP, and subsidiaries.

continued on next page.

properly accounting for rent holidays, should determine those effects using the method of accounting adopted by the company (i.e., either the Expense Method or the Capitalization Method).

It is critical that a thorough analysis be performed to determine whether or not an entity previously has elected an accounting policy with respect to rental costs incurred during a construction period. If an entity previously had recognized rents during the construction period in the income statement (i.e., the Expense Method), then it would not be acceptable to change to the Capitalization Method in connection with a restatement. Conversely, if an entity previously had adopted the Capitalization Method, it would not be acceptable to change to the Expense Method for the periods restated. In evaluating whether an entity previously had adopted a policy with respect to rents incurred during the construction period, entities should review their prior accounting treatment for any such rents incurred. For example, entities should review how they previously accounted for rental costs related to leased property in major metropolitan areas (e.g., New York) where free or reduced rent periods are uncommon, and where the company commenced payment of rents prior to or during the construction period. A pattern of having recognized rents, including cash rents, incurred during the construction period in the income statement would indicate that an entity previously had adopted the Expense Method of accounting. As such, it would be inappropriate for the entity to adopt the Capitalization Method in connection with a restatement.

While it is acceptable to capitalize a portion of straight-line rent allocable to the construction period, the Capitalization Method generally is not preferable to the Expense Method. Accordingly, once an entity has established a policy to expense rents as incurred, whether or not such a policy election was made in connection with correcting the entity's accounting for rent holidays, it would be very difficult for a company to conclude that a change in accounting policy to capitalize those costs is preferable. However, because such a determination is highly fact dependent, a company should consult with their independent auditors to ensure that their auditor agrees with the company's conclusion as to preferability.

Since companies have a choice between two acceptable accounting methods, they should disclose their accounting policy for rent during a construction period in accordance with APB Opinion No. 22, *Disclosure of Accounting Policies.*

Back to top

* * *

As used in this document, the term "Deloitte" includes Deloitte & Touche LLP, Deloitte Consulting LLP, and subsidiaries.

continued on next page.

What is and How to Subscribe DART?

Deloitte makes available, on a subscription basis, its online library of accounting and financial disclosure literature. Called the Deloitte Accounting Research Tool (DART), the library includes material from the FASB, the EITF, the AICPA, the SEC, and the IASB, in addition to Deloitte's own accounting manual and other interpretative accounting guidance.

Updated every business day, DART has an intuitive design and navigation system, which, together with its powerful search features, enables users to quickly locate information anytime, from any computer. Additionally, DART subscribers receive periodic e-mails highlighting recent additions to the DART library.

The fee for a subscription to the DART is $1,500 per person per year plus applicable sales tax. You can subscribe to the DART on-line and pay using any of the following credit cards: American Express, Diners Club, Master Card, or Visa. You can also subscribe to DART by calling 1-800-877-0145.

For more information, including subscription details and an online DART demonstration, visit: http://www.deloitte.com/us/dart

Back to top

This document is intended for non-US based companies and can be distributed externally to clients and prospective clients.

Deloitte & Touche LLP is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte & Touche LLP shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, the term “Deloitte” includes Deloitte & Touche LLP, Deloitte Consulting LLP, and subsidiaries.

continued on next page.

About Deloitte

Deloitte, one of the nation's leading professional services firms, provides audit, tax, consulting, and financial advisory services through nearly 30,000 people in more than 80 U.S. cities. Known as an employer of choice for innovative human resources programs, the firm is dedicated to helping its clients and its people excel. "Deloitte" refers to the associated partnerships of Deloitte & Touche USA LLP (Deloitte & Touche LLP and Deloitte Consulting LLP) and subsidiaries. Deloitte is the U.S. member firm of Deloitte Touche Tohmatsu. For more information, please visit Deloitte's Web site at www.deloitte.com/us.

Deloitte Touche Tohmatsu is an organization of member firms devoted to excellence in providing professional services and advice. We are focused on client service through a global strategy executed locally in nearly 150 countries. With access to the deep intellectual capital of 120,000 people worldwide, our member firms, including their affiliates, deliver services in four professional areas: audit, tax, consulting, and financial advisory services. Our member firms serve more than one-half of the world's largest companies, as well as large national enterprises, public institutions, locally important clients, and successful, fast-growing global growth companies.

Deloitte Touche Tohmatsu is a Swiss Verein (association), and, as such, neither Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each of the member firms is a separate and independent legal entity operating under the names "Deloitte," "Deloitte & Touche," "Deloitte Touche Tohmatsu," or other, related names. The

Copyright © 2005 Deloitte Development LLC. All rights reserved