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FINANCIAL ACCOUNTING STANDARDS BOARD
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December 3, 2004

TO: MEMBERS OF THE FASB EMERGING ISSUES TASK FORCE

Included are the final minutes of the November 17–18, 2004 meeting of the FASB Emerging Issues Task Force and an inventory of open issues for the next EITF meeting. Also included is a confidential version of the minutes that has been marked for changes from the December 1 draft. After your review, please discard the confidential marked version of the minutes.

March Meeting Time and Location
The next EITF meeting will be held on **March 16–17, 2005,** at the FASB offices in Norwalk, Connecticut. Based on our preliminary thoughts on the agenda, the meeting will start at **1:00 p.m.** on March 16 and conclude no later than **4:00 p.m.** on March 17.

Minutes
We will make minutes available **after 4:00 p.m.** on the following days:

Draft minutes available	**March 22, 2005**
Final minutes available	**April 5, 2005**

Please call me at extension x212 if you have any questions.

Sincerely,

Landon B. Westerlund
Practice Fellow

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MINUTES OF THE NOVEMBER 17–18, 2004 MEETING OF THE FASB EMERGING ISSUES TASK FORCE

Location: FASB Offices
401 Merritt 7
Norwalk, Connecticut

Wednesday, November 17, 2004
Starting Time: 1:00 p.m.
Concluding Time: 5:15 p.m.

Thursday, November 18, 2004
Starting Time: 8:00 a.m.
Concluding Time: 3:20 p.m.

Task Force Members Present:
Lawrence W. Smith (Chairman)
Frank H. Brod
Jack T. Ciesielski
Mitchell A. Danaher
Leland E. Graul
Joseph F. Graziano
John M. Guinan
Stuart H. Harden
David L. Holman
James A. Johnson
David B. Kaplan
Louis W. Matusiak, Jr.
Ashwinpaul C. (Tony) Sondhi
Richard H. Stock
Lawrence E. Weinstock
Mark M. Bielstein (AcSEC Observer)
Scott A. Taub (SEC Observer)

Task Force Members Absent:
None

Others at Meeting Table:
Robert H. Herz, FASB Board Member
George J. Batavick, FASB Board Member
Gary S. Schieneman, FASB Board Member
Katherine Schipper, FASB Board Member
*Leslie F. Seidman, FASB Board Member
*Edward W. Trott, FASB Board Member
Russell G. Golden, FASB Senior Technical Advisor
Landon B. Westerlund, FASB Practice Fellow
Shelly C. Luisi, SEC Senior Associate Chief Accountant
Chad Kokenge, SEC Professional Accounting Fellow
* Richard Graff, Mining Industry Working Group Representative[1]
* Shannon Warren, JPMorganChase[2]
* Steven P. Belcher, FASB Practice Fellow
* Christopher J. Larson, FASB Practice Fellow
* Paul G. Laurenzano, FASB Practice Fellow
* Stuart J. Moss, FASB Practice Fellow
* Lisa M. Munro, FASB Practice Fellow
* Reginald D. Oakley, FASB Practice Fellow
* Randall S. Sogoloff, FASB Practice Fellow
* Amie N. Thuener, FASB Practice Fellow

* For certain issues only.

[1] Invited to discuss with the Task Force issues relating to EITF Issue No. 04-6, "Accounting for Stripping Costs in the Mining Industry."
[2] Representative of the FASB Implementation Issues Resource Group for FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, invited to discuss with the Task Force issues relating to EITF Issue No. 04-7, "Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity."

ADMINISTRATIVE MATTERS

- Prior Meeting Minutes. An FASB staff member solicited objections to the final minutes of the September 29–30, 2004 meeting. No objections were noted.

- The Task Force discussed the report on the EITF Agenda Committee meeting held on November 2, 2004. The following decisions were made by the Agenda Committee:

a. *The Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option That Otherwise Is Not Convertible or Not Currently Convertible Based on a Contingency.* The Agenda Committee decided to add this Issue to the EITF's agenda.

b. *Accounting for Buy/Sell Transactions of Oil.* The Agenda Committee decided to add this Issue to the EITF's agenda. The Agenda Committee asked the EITF to address whether transactions under buy/sell arrangements, as described in this Issue, should be considered nonmonetary transactions under APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, and, if so, whether there are circumstances under which the transactions should be recognized at fair value. Refer to the discussion of EITF Issue No. 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty," elsewhere in these minutes.

- Comment letters on the following Issues were reported as received:

a. EITF Issue No. 03-13, "Applying the Conditions in Paragraph 42 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in Determining Whether to Report Discontinued Operations " (2 comment letters)
b. EITF Issue No. 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty" (1 comment letter).

- The Task Force Chairman provided an update on the proposed FASB Staff Position EITF 03-1-a, "Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1, 'The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.'" The Chairman stated that the FASB staff is evaluating constituents' comments on the proposed FSP EITF 03-1-a and expects to ask the Board to reconsider the impairment model under Issue 03-1 in early 2005. The Chairman observed that FSP EITF 03-1-1, "Effective Date of Paragraphs 10–20 of EITF Issue No. 03-1," delays the effective date for the measurement and recognition guidance contained in paragraphs 10–20 of Issue 03-1, but does not suspend the requirement to recognize other-than-temporary impairments as required by existing authoritative literature.[1] The Chairman also noted that an investor with a cost method investment should

[1] During the period of the delay, an entity should continue to apply relevant "other-than-temporary" guidance, such as paragraph 16 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, including the guidance referenced in footnote 4 of that paragraph, paragraph 6 of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," and SEC Staff Accounting Bulletin No. 59, "Accounting for Noncurrent Marketable Equity Securities," as applicable.

apply the guidance in paragraph 8 of Issue 03-1 for purposes of evaluating whether such an investment is impaired. The Chairman emphasized that the disclosure guidance in paragraphs 21 and 22 of Issue 03-1 remains effective.

- A FASB staff member updated the Task Force on two Board agenda decisions from its November 10, 2004 meeting. The Board considered and decided to add the following projects to the FASB agenda at the recommendation of the Task Force:

a. Determination of the Useful Life of Renewable Intangible Assets under FASB Statement No. 142, *Goodwill and Other Intangible Assets* (formerly EITF Issue No. 03-9)

b. Accounting for Suspended Well Costs (formerly EITF Issue No. 04-9)

- The Task Force held a closed administrative session to discuss EITF operating procedures.

- The Task Force Chairman announced that Mr. John M. Guinan would be retiring from KPMG LLP and, as a result, has relinquished his position on the EITF. The Task Force Chairman thanked Mr. Guinan for his service and announced that Mr. Mark M. Bielstein, currently the EITF AcSEC Observer, will replace Mr. Guinan as the Task Force member representing KPMG LLP beginning with the March 16–17, 2005 EITF meeting.

- March 2005 EITF Meeting: The FASB staff asked Task Force members to anticipate a two-day EITF meeting to be held on March 16–17, 2005.

CONSENSUS MODIFICATION

Issue No. 04-8

Title: The Effect of Contingently Convertible Instruments on Diluted Earnings per Share

Date Discussed: November 17–18, 2004

At the September 29–30, 2004 EITF meeting, the Task Force reached a consensus on Issue 04-8 that was then ratified by the Board at the October 13, 2004 Board meeting.

Currently, the effective date of the consensus in Issue 04-8 coincides with the effective date of the proposed Statement that amends FASB Statement No. 128, *Earnings per Share* (the proposed Statement). At the time of the September EITF meeting, the FASB staff expected that the consensus would be applied to reporting periods ending after the effective date of the proposed Statement, which was expected to be December 15, 2004. The FASB staff now expects that the proposed Statement will be issued in the first quarter of 2005, and its effective date will be deliberated at a future Board meeting. The FASB staff believes that the Task Force intended, and constituents now expect, the effective date of Issue 04-8 to be for periods ending after December 15, 2004.

The FASB staff asked the Task Force to reconsider the effective date of Issue 04-8. The staff proposed that the effective date of Issue 04-8 not be linked to the effective date of the proposed Statement and that the consensus should be effective for reporting periods ending after December 15, 2004.

At the November 17–18, 2004 EITF meeting, the Task Force agreed to change the transition provisions of the consensus to require that the guidance be applied to reporting periods ending after December 15, 2004.

Changes to the Abstract

Paragraph 6 under "Transition" will be replaced by the following:

> The consensus in this Issue should be applied to reporting periods ending after December 15, 2004.

In addition, the Status section will be updated with the following:

> At the November 17–18, 2004 meeting, the Task Force discussed the effective date of the consensus in this Issue. The consensus would have been applied to reporting periods ending after the effective date of the proposed Statement that amends Statement 128, which was expected to be December 15, 2004. The FASB staff indicated that it now expects that the proposed Statement will be issued in the first quarter of 2005, and its effective date will need to be deliberated at a future Board meeting. The Task Force agreed to change the transition provisions

of the consensus to require that the guidance in this Issue be applied to reporting periods ending after December 15, 2004.

Board Ratification

At its November 30, 2004 meeting, the Board ratified the change to the effective date for the guidance in this Issue.

CONSENSUS MODIFICATION

Issue No. 04-10

Title: Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds

Date Discussed: November 17–18, 2004

At the September 29–30, 2004 EITF meeting, the Task Force reached a consensus on Issue 04-10 that was then ratified by the Board at the October 13, 2004 Board meeting.

At the September EITF meeting, the Task Force also agreed to remove EITF Issue No. 04-E, "The Meaning of Similar Economic Characteristics," from the EITF's agenda. The FASB staff is in the process of drafting a proposed FASB Staff Position (FSP) to provide guidance in determining whether two or more operating segments have similar economic characteristics and will be recommending to the Board that the proposed FSP be posted to the FASB website for public comment. The FASB staff anticipates that the final issuance of the FSP will be in March 2005, with a likely effective date for fiscal periods ending after March 15, 2005.

Members of the Task Force have raised concerns about the effective date of Issue 04-10 and the anticipated effective date of the FSP. Since the issues are interrelated, those members believe that the effective date of Issue 04-10 should coincide with the effective date of the FSP.

The FASB staff asked the Task Force to consider whether the effective date for Issue 04-10 should be delayed until the anticipated FSP becomes effective.

At the November 17–18, 2004 EITF meeting, the Task Force agreed that the effective date of the consensus in Issue 04-10 should coincide with the effective date of the anticipated FSP that will address the meaning of similar economic characteristics. Accordingly, the Task Force has delayed the effective date of Issue 04-10. However, early application of this consensus is permitted.

Changes to the Abstract

Paragraph 7 will be replaced with the following:

> The effective date of the consensus in this Issue will coincide with the effective date of an anticipated FASB Staff Position (FSP) that will provide guidance in determining whether two or more operating segments have similar economic characteristics. The consensus should be applied to fiscal years ending after that effective date, and the corresponding information for earlier periods, including interim periods, should be restated unless it is impractical to do so. Early application is permitted. The FASB staff anticipates that the final issuance of the FSP and its effective date will be in 2005.

The following paragraph will be added to the Status section:

> At the November 17–18, 2004 meeting, the Task Force discussed the effective date of the consensus in this Issue. The consensus would have been applied to fiscal years ending after October 13, 2004. The FASB staff is in the process of drafting a proposed FSP on a related issue that will provide guidance in determining whether two or more operating segments have similar economic characteristics and will be recommending to the Board that the proposed FSP be posted to the FASB website for public comment. The FASB staff anticipates that the final issuance of the FSP and its effective date will be in 2005. Accordingly, the Task Force agreed that the effective date of this Issue should coincide with the effective date of the FSP.

Board Ratification

At its November 30, 2004 meeting, the Board ratified the change to the effective date for the guidance in this Issue.

DISCUSSION OF AGENDA TECHNICAL ISSUES

Issue No. 03-13

Title: Applying the Conditions in Paragraph 42 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in Determining Whether to Report Discontinued Operations

Dates Discussed: November 12–13, 2003; March 17–18, 2004; June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004

References: FASB Statement No. 57, *Related Party Disclosures*

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*

APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*

International Financial Reporting Standard No. 5, *Non-current Asset Held for Sale and Discontinued Operations*

Introduction

1. The FASB staff established a Working Group to assist in the development of a model for evaluating (a) which cash flows are to be considered in determining whether cash flows have been or will be eliminated and (b) what types of continuing involvement constitute significant continuing involvement. The Working Group generally agreed that current practice with respect to applying the criteria in paragraph 42 of Statement 144 has not resulted in broadening the reporting of discontinued operations, which appears to have been the Board's intent in Statement 144. The requirement to *eliminate* all cash flows of the component from the ongoing operations of the entity has been interpreted in a very restrictive fashion, which the Working Group believes is primarily due to a lack of guidance to assist in the determination of what constitutes "cash flows of the component." The difficulty in determining what cash flows constitute the cash flows of the component can arise, for instance, when the seller engages in activities with the component after its disposal. Often, those activities generate continuing cash flows to the seller, which may or may not be considered cash flows of the component. The Working Group has agreed that the evaluation of what cash flows are to be considered in determining whether cash flows have been or will be eliminated and what types of continuing involvement constitute significant continuing involvement should be based on many factors.

2. With respect to significant continuing involvement, the Working Group generally believes that paragraph 42(b) of Statement 144 is intended to address situations in which the seller continues to have significant involvement in the operations of a component after it is sold and is not intended to apply to other types of involvement in the disposed component. The Working Group generally agreed that the evaluation of whether an entity has significant continuing involvement in the operations of the component should be based on significance from the perspective of the disposed component and on relevant facts and circumstances.

3. The Working Group noted that the cash flows of the component include gross cash flows (cash inflows and cash outflows) that are directly associated with revenue-producing and cost-generating activities of the component, that is, cash flows directly associated with the operations of the component. Situations in which the seller engages in activities with the component after its disposal often result in continuing cash flows to the seller. The Working Group noted that the activities that generate continuing cash flows may or may not have similar characteristics as compared with the activities that generated the cash flows prior to the disposal of the component.

4. The Working Group generally agreed that the determination of whether the "continuing cash flows" constitute "cash flows of the component" should be based on an evaluation of whether the characteristics of the activities that generate the continuing cash flows are similar to the characteristics of the activities that generated the cash flows of the component prior to its disposal.

5. The Working Group discussed the characteristics that should be included in this evaluation, of which the following were noted:

- Whether the products sold and services provided are similar in nature
- Whether the customers who purchase the products sold and services provided are similar
- Whether the geographic regions in which products are sold and services are provided are similar
- Whether the methods used to distribute products and provide services are similar
- Whether the extent of decision-making ability over the operations is similar
- Whether degrees of involvement in the activities are similar (passive versus active)
- Whether degrees of financial interest are similar (obligation to absorb losses and ability to receive residual returns).

6. The Working Group agreed that the determination of whether the entity has significant continuing involvement in the operations of the component after the disposal transaction should be based on facts and circumstances. The Working Group further agreed that any guidance should provide indicators of significant continuing involvement along with examples that will assist preparers and auditors in evaluating the indicators. The Working Group believes that the Task Force should consider whether the proposed model should include a bright-line test to assist in the determination as to what constitutes "significant."

7. The Working Group generally agreed that an evaluation of significant continuing involvement should be based on both quantitative and qualitative assessments and should be from the perspective of the disposed component. The Working Group discussed indicators of significant continuing involvement, of which the following were noted:

a. The entity retains an interest in the disposed component sufficient to enable it to exert significant influence over the component's operating and financial policies.
b. The entity and the buyer are parties to a significant contract or agreement, such as the relationship between a customer and a supplier, when one entity provides management services to another, or when two entities enter into a transitional support agreement that

involves the disposed component. The determination as to whether this constitutes significant continuing involvement should be based on the following factors:

(1) Significance of the contract or agreement to the overall operations of the disposed component,
(2) The rights conveyed by the contract to each party, and
(3) Whether the contract was carried out on an arm's-length basis.

Each factor should be evaluated in determining whether a contract or agreement would constitute significant continuing involvement.

c. The entity participates significantly in future profits of the disposed component. The determination as to whether this constitutes significant continuing involvement should be based on the following factors: (1) the extent to which the entity is involved in the operations of the disposed component, (2) the significance of the cash that may be received in comparison to the overall cash flows from the operations of the entity disposed of, and (3) the term or length of the profit participation.

8. The Working Group discussed the assessment period with respect to determining when the criteria in paragraph 42 of Statement 144 have been met and formulated the following three views:

a. The assessment of whether an entity meets the criteria of paragraph 42 should be made during the period that includes the point at which the component initially meets the criteria to be classified as held for sale and the date the component is actually disposed of.
b. The assessment of whether an entity meets the criteria of paragraph 42 should be made during the period that includes the point at which the component initially meets the criteria to be classified as held for sale and one year after the date the component is actually disposed of.
c. The assessment of whether an entity meets the criteria of paragraph 42 should be made beginning when the component initially meets the criteria to be classified as held for sale and should be ongoing.

Issue

9. The issues are:

Issue 1— The cash flows that should be considered in the determination of whether cash flows of the disposed component have been or will be eliminated from the ongoing operations of the entity

Issue 2— The types of continuing involvement that constitute significant continuing involvement in the operations of the disposed component

Issue 3— The appropriate (re)assessment period in determining whether the criteria in paragraph 42 have been met.

Prior EITF Discussion

10. At the November 12–13, 2003 EITF meeting, the Task Force discussed the Working Group's proposed approach for assessing whether the criteria in paragraph 42 of Statement 144 have been met for purposes of classifying the results of operations of a component of an entity that either has been disposed of or is classified as held for sale as discontinued operations. That proposed guidance focuses on (a) the cash flows that constitute "cash flows of the component" and (b) the continuing involvement that constitutes significant continuing involvement.

11. The Task Force agreed with the general direction of the Working Group's proposed approach but asked the Working Group to further refine and articulate the principles set forth in the proposed approach and to provide examples of the application of the proposed approach to specific fact patterns.

12. With respect to the appropriate assessment period (Issue 3), the Task Force reached a tentative conclusion that the appropriate assessment period should include the point at which the component initially meets the criteria to be classified as held for sale and one year after the date the component is actually disposed of. The assessment should be based on all facts and circumstances, including management's intent and ability to eliminate the cash flows of the disposed component from its operations and management's intent and ability not to have significant continuing involvement in the operations of the disposed component. If the criteria in paragraph 42 are not expected to be met within one year after the disposal date, the component's operations should be reclassified from discontinued operations. If the criteria in paragraph 42 are met or are expected to be met within one year after the disposal date, the component's operations should be classified as discontinued operations. The Task Force observed that events or circumstances beyond an entity's control may extend the period over which cash flows of the disposed component continue or over which significant continuing involvement in the disposed component remains. Therefore, the Task Force also agreed that an exception to the one-year period should apply in situations described in paragraph 31 of Statement 144.

13. At the March 17–18, 2004 EITF meeting, the Task Force discussed the Working Group's proposed approach for assessing whether cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity, which focuses on whether continuing cash flows are direct or indirect cash flows. Cash flows of the component would not be eliminated if the continuing cash flows are considered direct cash flows. The determination as to whether the continuing cash flows are direct or indirect is based on an evaluation of a set of indicators. That set of indicators focuses on the characteristics of the cash inflows to and cash outflows from the entity following the disposal. The indicators specifically address (a) the customers who purchase products or services of the entity that are similar to products or services of the disposed component, (b) the costs associated with the similar products or services sold, and (c) the nature of the products or services sold to or purchased from the disposed component. The relative strength of each indicator is considered in relation to the other indicators to determine whether the cash flows are direct or indirect cash flows of the disposed component.

14. The proposed approach for assessing whether the entity will have any significant continuing involvement in the operations of the component after the disposal transaction focuses on whether the entity has (a) the ability to influence the operating and/or financial policies of the disposed

component, (b) retained risk associated with the operations of the disposed component, or (c) the ability to restrict other third parties from obtaining benefits from the disposed component.

15. The Task Force discussed and expressed general support for the direction of the Working Group's proposed approach. The Task Force asked the FASB staff to further refine and articulate the principles set forth in the proposed approach and provide more guidance on the application of the proposed approach to the specific examples. Additionally, the Task Force requested that the FASB staff develop additional examples for specific fact patterns raised by some Task Force members.

16. At the June 30–July 1, 2004 EITF meeting, the Task Force discussed the Working Group's revised proposed approach for assessing whether the criteria in paragraph 42 of Statement 144 have been met for purposes of classifying the results of operations of a component of an entity that either has been disposed of or is classified as held for sale as discontinued operations.

17. The proposed approach for assessing whether cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity focuses on whether continuing cash flows are direct or indirect cash flows. Cash flows of the component would not be eliminated if the continuing cash flows to the entity are considered direct cash flows. The determination of whether cash flows are *direct* or *indirect* depends on the nature and significance of the cash flows and requires judgment. Direct cash flows include gross cash flows (cash inflows and cash outflows) that are directly associated with the revenue-producing and cost-generating activities of an entity. The revenue-generating activities (cash inflows) of a component have been continued and, therefore, are considered direct cash flows if (a) significant cash inflows are expected to be recognized by the remaining entity as a result of a migration of revenues from the disposed component after the disposal transaction or (b) significant cash inflows are expected to be received by the remaining entity as a result of the continuation of activities between the remaining entity and the disposed component after the disposal transaction. The cost-generating activities (cash outflows) of the component have been continued and, therefore, are considered direct cash flows if (c) significant cash outflows are expected to be recognized by the remaining entity as a result of a migration of costs from the disposed component after the disposal transaction or (d) significant cash outflows are expected to be recognized by the remaining entity as a result of the continuation of activities between the remaining entity and the disposed component after the disposal transaction.

18. The proposed approach for assessing whether the remaining entity will have any significant continuing involvement in the operations of the component following the disposal transaction focuses on whether the entity has (a) the ability to influence the operating and/or financial policies of the disposed component, (b) retained risk associated with the operations of the disposed component, or (c) the ability to obtain benefits associated with the ongoing operations of the disposed component. The determination as to whether the remaining entity has significant continuing involvement is based on a quantitative and qualitative assessment from the perspective of the disposed component and should take into consideration all types of continuing involvement, individually and in the aggregate. The proposed approach provides two categories of relationships that should be considered in determining whether an entity has significant continuing involvement in the operations of the component: (a) the entity retains an interest in

the disposed component sufficient to enable it to exert significant influence over the component's operating and financial policies and (b) the entity and the buyer (or disposed component) are parties to a contract or agreement that, based on a consideration of several factors, constitutes significant continuing involvement.

19. The Task Force discussed and expressed general support for the scope and direction of the Working Group's proposed approach; however, the Task Force did not support specifying a threshold (that is, a specific percentage) to be used in evaluating whether continuing cash flows are significant. The Task Force asked the FASB staff to further refine and articulate how an entity should evaluate the nature of the cash flows to determine whether the cash flows need to be evaluated for significance in the proposed approach. Additionally, the Task Force asked the FASB staff to further articulate the basis for the conclusions that were reached in the examples in the Issue Summary for this Issue and to apply the proposed approach to the examples in Statement 144. The FASB staff also will propose disclosures for disposed components that are presented as discontinued operations for the Task Force's consideration.

20. At the September 29–30, 2004 EITF meeting, the Task Force reached a tentative conclusion on an approach for evaluating whether the criteria in paragraph 42 of Statement 144 have been met for purposes of classifying the results of operations of a component of an entity that either has been disposed of or is classified as held for sale as discontinued operations. Additionally, the Task Force requested that the FASB staff incorporate the following tentative conclusions into that approach. The FASB staff incorporated the following tentative conclusions into a draft abstract.

a. Include an assessment period for determining when the criteria in paragraph 42 of Statement 144 have been met. The assessment period should include the point at which the component initially meets the criteria to be classified as held for sale through one year after the date the component is actually disposed of. The assessment should be based on all facts and circumstances, including management's intent and ability (a) to eliminate the cash flows of the disposed component from its operations and (b) to not have significant continuing involvement in the operations of the disposed component. For one year after a component has been disposed of, an entity is required to reassess whether the criteria in paragraph 42 are expected to be met when significant events or circumstances occur that could change its current assessment.
b. Include a presumption that the continued sale of a commodity in an active market is a "migration." That presumption can be overcome based on facts and circumstances, such as the lack of similarity of the commodity and whether the sale of the commodity after the disposal transaction occurs in a different geographic region as compared with the sale of the commodity before the disposal transaction. For purposes of this Issue, the term *commodity* is defined as products whose units are interchangeable and immediately marketable at quoted prices.
c. Retain the requirement to evaluate only gross cash inflows and gross cash outflows (as opposed to other operating measures) in determining whether continuing cash flows are significant.
d. Modify the definition of *continuing involvement* such that it does not explicitly include (1) the retention of risk associated with the ongoing operations of the disposed component or

(2) the ability to obtain benefits associated with the ongoing operations of the disposed component. Incorporate these concepts into the determination as to whether the ongoing entity has the ability to influence the operating and (or) financial policies of the disposed component.

e. Require disclosure of the methodology for determining the amounts presented in discontinued operations in situations in which the ongoing entity will engage in a "continuation of activities" with the disposed component after its disposal. If such amounts presented in discontinued operations include intercompany revenues and expenses, those amounts should be disclosed for all periods presented.

f. Clarify that a "migration" occurs when there is an expectation that the ongoing entity would continue to generate revenues and costs from the sale of similar products or services to specific customers of the disposed component.

21. The Task Force also reached a tentative conclusion that the consensus would be applied to a component of an enterprise that is either disposed of or classified as held for sale in fiscal periods beginning after December 15, 2004. Previously reported operating results related to disposal transactions initiated within an enterprise's fiscal year that includes the date that this consensus is ratified may be reclassified to reflect the consensus.

22. The FASB staff posted the draft abstract to the FASB's website on October 15, 2004, for a 15-day comment period.

Current EITF Discussion

23. At the November 17–18, 2004 EITF meeting, the Task Force reached a consensus on an approach for evaluating whether the criteria in paragraph 42 of Statement 144 have been met for purposes of classifying the results of operations of a component of an entity that either has been disposed of or is classified as held for sale as discontinued operations. During its deliberations, the Task Force considered a number of issues that were raised by constituents. The Task Force reached the following conclusions on those issues, which are incorporated into the final draft abstract in Appendix 03-13A:

a. An assessment period may extend beyond one year after the component is actually disposed of in situations in which events or circumstances beyond an entity's control extend the period required to eliminate the direct cash flows of the disposed component or eliminate the significant continuing involvement in the ongoing operations of the disposed component provided that the entity (1) takes the actions necessary to respond to those situations and (2) expects to eliminate the direct cash flows and the significant continuing involvement.

b. The evaluation of whether the criteria in paragraph 42 of Statement 144 have been met for a component that is either disposed of or classified as held for sale at the balance sheet date should include significant events or circumstances that occur after the balance sheet date but before the issuance of the financial statements. This guidance is limited to whether the operations of a component should be presented as discontinued operations.

c. For the purposes of this Issue, the term *commodity* means products whose units are interchangeable, are traded on an active market where customers are not readily identifiable, and are immediately marketable at quoted prices.

d. The examples in Exhibit 03-13B assume that the disposed asset (or assets) meet the definition of a component in paragraph 41 of Statement 144 and are not intended to provide guidance for making that determination.

24. In addition, the Task Force declined to provide guidance on whether entities may report in continuing operations insignificant dispositions that are otherwise required to be reported as discontinued operations. The Task Force also decided not to expand the definition of *migration* to include situations in which the cash flows of a disposed component are replaced by cash flows from similar components that are generated from different customers.

25. The Task Force also reached a consensus that the guidance would be applied to a component of an enterprise that is either disposed of or classified as held for sale in fiscal periods beginning after December 15, 2004. Operating results related to a component that is either disposed of or classified as held for sale within an enterprise's fiscal year that includes the date that this consensus is ratified may be classified to reflect the consensus.

Board Ratification

26. At its November 30, 2004 meeting, the Board ratified the consensus reached by the Task Force on this Issue.

Status

27. No further EITF discussion is planned.

Appendix 03-13A

EITF Abstracts (DRAFT[1])

Issue No. 03-13

Title: Applying the Conditions in Paragraph 42 of FASB Statement No. 144 in Determining Whether to Report Discontinued Operations

Dates Discussed: November 12–13, 2003; March 17–18, 2004; June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004

References: FASB Statement No. 57, *Related Party Disclosures*

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*

APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*

ISSUE

1. Paragraph 42 of Statement 144 states that:

> The results of operations of a component of an entity that either has been disposed of or is classified as held for sale shall be reported in discontinued operations in accordance with paragraph 43 if both of the following conditions are met: (a) the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction and (b) the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.

2. Consideration of the guidance in paragraph 42 of Statement 144 has generated questions about how to apply the criterion that the operations and cash flows be *eliminated* from the ongoing operations of the reporting entity (the "ongoing entity"). Specifically, which cash flows of the disposed component have to be eliminated from the ongoing operations of the entity? Additionally, questions have been raised about the types of continuing involvement that constitute significant continuing involvement.

[1] This draft abstract was prepared to facilitate discussion of the guidance on which the Task Force reached its consensus and contains all substantive aspects of the consensus. The final abstract, which will be included in the next update for *EITF Abstracts*, may contain nonsubstantive editorial revisions.

3. The issues are:

Issue 1— How an ongoing entity should evaluate whether the operations and cash flows of a disposed component have been or will be eliminated from the ongoing operations of the entity

Issue 2— The types of continuing involvement that constitute significant continuing involvement in the operations of the disposed component.

EITF DISCUSSION

Issue 1

4. The Task Force reached a consensus on Issue 1 that the evaluation of whether the operations and cash flows of a disposed component have been or will be eliminated from the ongoing operations of the entity depends on whether continuing cash flows have been or are expected to be generated and, if so, whether those continuing cash flows are *direct* or *indirect*. Continuing cash flows are cash inflows or outflows that are generated by the ongoing entity and are associated with activities involving a disposed component. If continuing cash flows are generated, the determination as to whether those continuing cash flows are direct or indirect should be based on their *nature* and *significance*. If any continuing cash flows are *direct*, the cash flows have not been eliminated and the operations of the component should not be presented as a discontinued operation. Conversely, if all continuing cash flows are *indirect* (that is, not direct), the cash flows are considered to be eliminated and the disposed component meets the paragraph 42(a) criterion to be considered a discontinued operation. The assessment as to whether continuing cash flows are direct cash flows should be based on management's expectations using the best information available.

5. Cash flows[2] of a component include gross cash flows (cash inflows and cash outflows) that are associated with the revenue-producing and cost-generating activities of that component (that

[2] The cash flows that are associated with the revenue-producing and cost-generating activities are the same cash flows utilized in the Statement 144 impairment analysis under the "held and used" model.

is, "direct" cash flows). The intention of the criterion in paragraph 42(a) is to determine whether, in substance, the ongoing entity continues either the revenue-producing activities (cash inflows) or the cost-generating activities (cash outflows) of the disposed component after the disposal transaction.

6. The revenue-producing activities (cash inflows) of the component have been continued and therefore are considered direct cash flows if:

a. Significant cash inflows are expected to be recognized by the ongoing entity as a result of a migration[3] of revenues from the disposed component after the disposal transaction; or
b. Significant cash inflows are expected to be received by the ongoing entity as a result of the continuation of activities[4] between the ongoing entity and the disposed component after the disposal transaction.

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[3] The term *migration* means the ongoing entity expects to continue to generate revenues and (or) incur expenses from the sale of similar products or services to specific customers of the disposed component. An entity is not required to track the identity of the individual customers who are expected to migrate in order to conclude a migration has occurred (for example, an entity that closes (or sells) several smaller retail stores and opens a superstore in the immediate area would likely conclude that a migration of specific retail customers is expected, even if the entity has not tracked the identity of all its individual customers). There is a presumption that if the ongoing entity continues to sell a similar commodity on an active market after the disposal transaction, the revenues and (or) costs would be considered a "migration." This presumption may be overcome based on facts and circumstances, such as the lack of similarity of the commodities or whether the sale of the commodity after the disposal transaction occurs in a different geographic region as compared with the sale of the commodity before the disposal transaction. For purposes of this Issue, the term *commodity* means products whose units are interchangeable, are traded on an active market where customers are not readily identifiable, and are immediately marketable at quoted prices.
[4] The term *continuation of activities* means the continuation of any revenue-producing or cost-generating activity through active involvement with the disposed component. For example, the ongoing entity sold products or services to or purchased products or services from the disposed component before its disposal (recognized as intercompany sales or cost of sales) and it continues to sell similar products or services to or purchase similar products or services from the disposed component or a related party, as defined in Statement 57, to the disposed component after its disposal (recognized as sales or cost of sales). After the disposal transaction, the former intercompany sales or cost of sales are no longer eliminated in consolidation, which will result in continuing cash inflows or outflows to the ongoing entity.

The cost-generating activities (cash outflows) of the component have been continued and therefore are considered direct cash flows if:

c. Significant cash outflows are expected to be recognized by the ongoing entity as a result of a migration[5] of costs from the disposed component after the disposal transaction; or

d. Significant cash outflows are expected to be recognized by the ongoing entity as a result of the continuation of activities[6] between the ongoing entity and the disposed component after the disposal transaction.

The Task Force reached a consensus that the guidance below should be used to evaluate whether continuing cash flows are direct cash flows.

Nature of Activities That Generate Continuing Cash Flows

7. In evaluating whether continuing cash flows are direct cash flows, the ongoing entity should first consider the nature of the activities that generate those continuing cash flows. A disposal transaction may result in the ongoing entity (a) recognizing revenues or costs that likely would have been generated by the disposed component absent the disposal transaction (a "migration") or (b) continuing any of the revenue-producing or cost-generating activities through active involvement with the disposed component (a "continuation of activities"). In situations in which continuing cash flows are being generated by the ongoing entity from either a migration or a continuation of activities, the ongoing entity should then determine whether the cash flows are significant. If continuing cash flows are not generated from either a migration or a continuation of activities, the ongoing entity would not need to determine whether the cash flows are significant but should perform an evaluation of the criteria in paragraph 42(b) to assess whether it has significant continuing involvement in the operations of the disposed component. Examples of continuing cash flows that would likely not be direct include, but are not limited to, (a) interest income recognized from seller-provided financing, (b) contingent consideration in a

[5] Refer to footnote 3.
[6] Refer to footnote 4.

business combination, (c) dividends on an investment, and (d) passive royalty interests in the disposed component's operations.

Significance of Continuing Cash Flows

8. If expected continuing cash inflows or outflows are the result of a migration of revenues or costs to the ongoing entity or a continuation of activities between the disposed component and the ongoing entity, the ongoing entity should consider whether the continuing cash flows will be significant. The evaluation as to whether continuing cash flows would be significant is a matter of judgment and should be based on a comparison between the expected continuing cash flows to be generated by the ongoing entity after the disposal transaction and the cash flows that would have been expected to be generated by the disposed component absent the disposal transaction. The cash flows that would have been expected to be generated by the disposed component should include cash flows from both third-party and intercompany transactions (the amount of cash flows attributed to intercompany transactions should be determined based on a consideration of the transactions as if they had been between unrelated third parties). Continuing cash inflows should be evaluated separately from continuing cash outflows in evaluating significance, regardless of whether income statement presentation is on a gross or net basis. If a determination is made that continuing cash inflows represent direct cash flows, an evaluation of cash outflows is not necessary. If a determination is made that continuing cash flows are indirect (cash inflows and cash outflows), the ongoing entity should perform an evaluation under the criterion in paragraph 42(b) to assess whether it has significant continuing involvement in the operations of the disposed component.

Issue 2

Significant Continuing Involvement

9. If the operations and cash flows of a disposed component have been (or will be) eliminated from the ongoing operations of an entity as a result of a disposal transaction (see paragraphs 4–8 for guidance on making that determination), an entity should evaluate whether the ongoing entity will have significant continuing involvement in the operations of the component after the

disposal transaction. The Task Force reached a consensus on Issue 2 that continuing involvement in the operations of the disposed component provides the ongoing entity with the ability to influence the operating and (or) financial policies of the disposed component. The retention of risk or the ability to obtain benefits should be considered in the overall evaluation of whether the ongoing entity has the ability to influence the operating and (or) financial policies of the disposed component. However, the retention of risk or the ability to obtain benefits associated with the ongoing operations of the disposed component does not indicate by itself that the ongoing entity has the ability to influence the operating and (or) financial policies of the disposed component resulting in continuing involvement. An interest in the disposed component or the existence of a contractual arrangement or other type of arrangement with the disposed component should be evaluated to determine whether the ongoing entity has continuing involvement with the disposed component.

10. The determination as to whether the continuing involvement is significant should be based on quantitative and qualitative assessments from the perspective of the disposed component. The assessment should consider all types of continuing involvement, individually and in the aggregate.

11. The following factors, among others, should be considered in evaluating whether continuing involvement constitutes significant continuing involvement:[7]

a. The ongoing entity retains an interest[8] in the disposed component sufficient to enable the ongoing entity to exert significant influence over the disposed component's operating and financial policies. Interests other than common stock or in-substance common stock may provide the ongoing entity with significant influence over the disposed component's

[7] The guidance in this paragraph should be used only to evaluate the criterion in paragraph 42(b) of Statement 144 and should not be used to evaluate the criterion in paragraph 42(a) of Statement 144 or to determine whether an entity meets the criteria for sale accounting or gain recognition set forth in other applicable accounting literature.

[8] An entity's holding of a call option to acquire an interest in the disposed component may be a form of continuing involvement. If the call option represents a form of continuing involvement, the determination of whether that continuing involvement is significant depends on a number of factors, including whether the call option is at fair value, when the call option becomes exercisable, and the percentage ownership underlying the call option.

operating and financial policies. A cost method investment in common stock or in-substance common stock alone would not be considered significant continuing involvement.

b. The ongoing entity and the buyer (or the disposed component) are parties to a contract or otherwise parties to an arrangement that in substance enables the ongoing entity to exert significant influence over the disposed component's operating and financial policies. Judgment is required in evaluating whether a contract or an arrangement constitutes significant continuing involvement, and all available information should be considered in performing the related analysis. The following factors should be considered in that regard; however, no one factor should be considered presumptive or determinative:
   (1) Significance of the contract or arrangement to the overall operations of the disposed component
   (2) The extent to which the ongoing entity is involved in the operations of the disposed component
   (3) The rights conveyed by the contract to each party
   (4) The pricing terms of the contract or arrangement.

12. The circumstances discussed in paragraph 44 of Statement 144 would not constitute continuing cash flows or continuing involvement. Examples include the following:

a. The resolution of contingencies that arise pursuant to the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser
b. The resolution of contingencies that arise from and that are directly related to the operations of the component prior to its disposal, such as environmental and product warranty obligations retained by the seller
c. The settlement of employee benefit plan obligations (pension, postemployment benefits other than pensions, and other postemployment benefits), provided that the settlement is directly related to the disposal transaction.

Assessment Period

13. The Task Force reached a consensus that the appropriate assessment period should include the point at which the component initially meets the criteria to be classified as held for sale or is disposed of through one year after the date the component is actually disposed of. The assessment should be based on all facts and circumstances, including management's intent and ability to (a) eliminate the cash flows of the disposed component from its operations and (b) not have significant continuing involvement in the operations of the disposed component. For one year after a component has been disposed of, an entity should reassess whether the criteria in paragraph 42 are expected to be met only when significant events or circumstances occur that may change its current assessment. If the occurrence of a significant event or circumstance at any time during the assessment period results in an expectation that the criteria in paragraph 42 will not be met by the end of the assessment period, the component's operations should not be presented as discontinued operations. If the occurrence of a significant event or circumstance at any time during the assessment period results in an expectation that the criteria in paragraph 42 will be met by the end of the assessment period, the component's operations should be presented as discontinued operations. Reclassification into and out of discontinued operations for all periods presented may be required during the assessment period.

14. The assessment period may extend beyond one year after the component is actually disposed of in situations in which events or circumstances beyond an entity's control extend the period required to eliminate the direct cash flows of the disposed component or eliminate significant continuing involvement in the ongoing operations of the disposed component provided that the entity (a) takes the actions necessary to respond to those situations and (b) expects to eliminate the direct cash flows and the significant continuing involvement.

15. The evaluation of whether the criteria in paragraph 42 are expected to be met for a component that is either disposed of or classified as held for sale at the balance sheet date should include significant events or circumstances that occur after the balance sheet date but before the issuance of the financial statements. This evaluation is solely for the purposes of determining the

presentation of discontinued operations pursuant to paragraph 42 of Statement 144 and does not apply to any other guidance in Statement 144.

16. Refer to the flowchart in Exhibit 03-13A for an illustration of the guidance in this Issue. Examples illustrating the application of the guidance in this Issue are included in Exhibit 03-13B.

Disclosures

17. The following information should be disclosed in the notes to the financial statements for each discontinued operation that generates continuing cash flows: (a) the nature of the activities that give rise to continuing cash flows, (b) the period of time continuing cash flows are expected to be generated, and (c) the principal factors used to conclude that the expected continuing cash flows are not direct cash flows of the disposed component. Additionally, for each discontinued operation in which the ongoing entity will engage in a "continuation of activities" with the disposed component after its disposal and for which the amounts presented in continuing operations after the disposal transaction include a continuation of revenues and expenses that were intercompany transactions (eliminated in consolidated financial statements) before the disposal transaction, intercompany amounts before the disposal transaction should be disclosed for all periods presented. The types of continuing involvement, if any, that the entity will have after the disposal transaction should be disclosed. That information should be disclosed in the period in which operations are initially classified as discontinued.

Transition

18. The consensus should be applied to a component of an enterprise that is either disposed of or classified as held for sale in fiscal periods beginning after December 15, 2004. Operating results related to a component that is disposed of or classified as held for sale within an enterprise's fiscal year that includes the date that this consensus is ratified may be classified to reflect the consensus.

Board Ratification

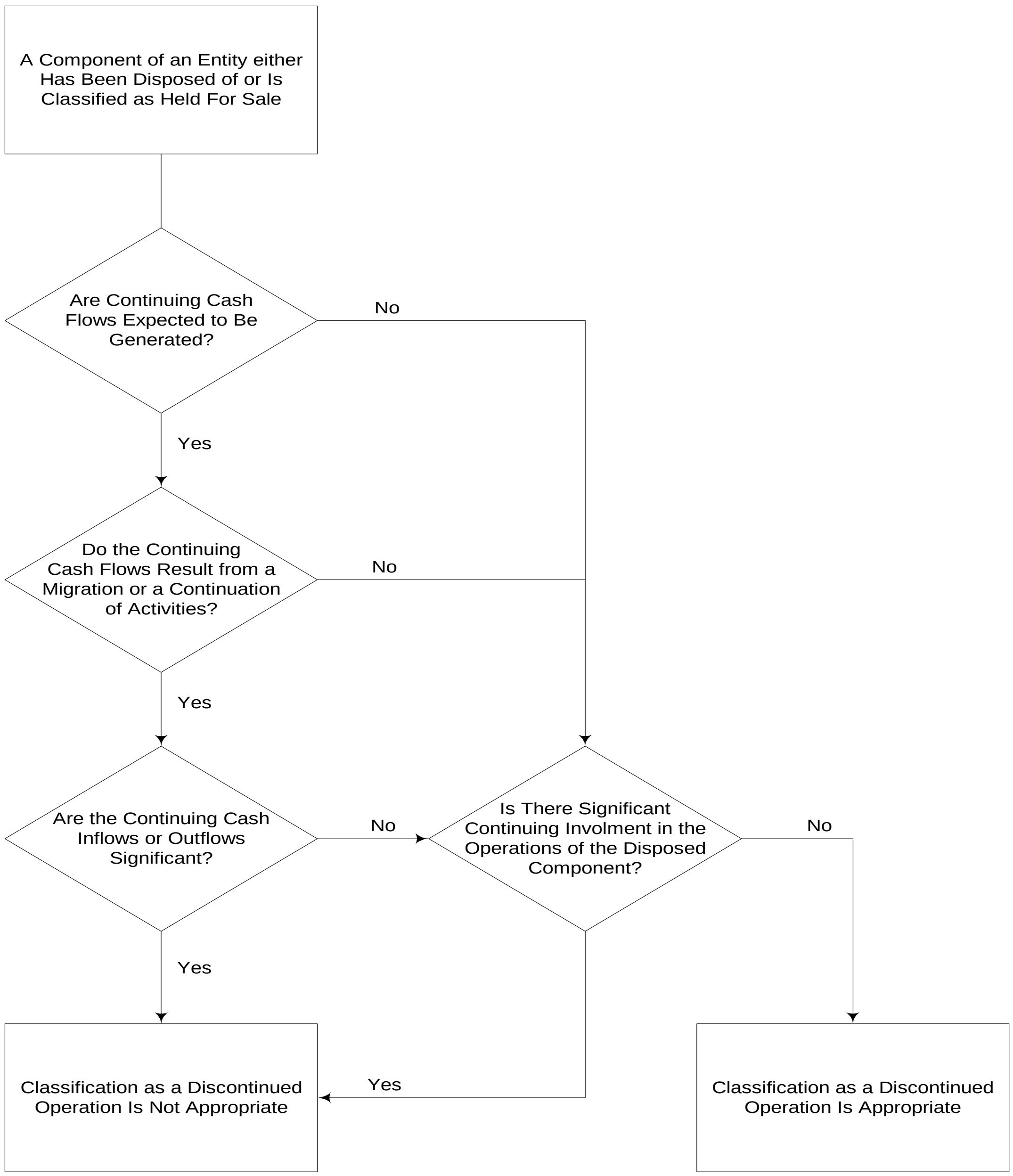
19. At its November 30, 2004 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

STATUS

20. No further EITF discussion is planned.

Exhibit 03-13A

DETERMINING WHEN A COMPONENT SHOULD BE CLASSIFIED AS A DISCONTINUED OPERATION[9]



[9] This diagram represents an overview of the provisions of this Issue with respect to determining whether a component that has been disposed of or is classified as held for sale should be classified as a discontinued operation. The diagram is a visual supplement to the written consensus. It should be neither interpreted to alter any requirements of the consensus nor considered a substitute for its requirements.

Exhibit 03-13B

EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUS ON ISSUE 03-13[10]

Example 1

An entity owns and operates retail stores that sell household goods. For that entity, each store is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each store is a component of the entity.

To expand its retail store operations in one region, the entity decides to close 2 of its retail stores and open a new "superstore" within 10 miles of the retail stores to be closed. The new superstore will continue to sell the household goods previously sold through the two retail stores along with other types of goods. The ongoing entity purchased and will continue to purchase the household goods from an unrelated wholesale distributor. The ongoing entity estimates that a migration of customers from the closed retail stores after the disposal transaction will result in the ongoing entity recognizing $400 thousand of sales ($200 thousand from each store). The ongoing entity estimates that each of the disposed components would have generated $250 thousand of sales absent the disposal transaction.

Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated by the ongoing entity from transactions with customers of the disposed component.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a migration, since customers are migrating from the closed retail stores to the superstore, which sells products similar to those sold in the closed retail

[10] The following example fact patterns and the related evaluations of the application of the consensus guidance in this Issue are provided solely to illustrate the application of that guidance as it relates to paragraphs 42(a) and 42(b) of Statement 144. The determination of what constitutes a component of an enterprise is governed by paragraph 41 of Statement 144, which is outside the scope of this Issue. Therefore, nothing contained in the following examples should be construed as guidance for the purposes of the appropriate determination of the components of the entities described in the examples.

stores. Therefore, an evaluation of the significance of the continuing cash flows must be performed.

Step 3: Are the continuing cash flows significant? Yes. The ongoing entity estimates that the continuing cash inflows will approximate 80 percent of the cash inflows that would have been generated by each of the components absent the disposal transaction. The ongoing entity believes that 80 percent is significant.

Conclusion: The continuing cash flows should be considered direct cash flows of the disposed components due to the significant cash inflows that are expected to be generated by the ongoing entity as a result of a migration of customers from the closed retail stores to the superstore. An evaluation of cash outflows is not necessary. Since the continuing cash flows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 2

An entity owns and operates retail stores and has Internet operations (website), all of which sell household goods. For that entity, each store is a component of the entity and the Internet operation is a component of the entity.

The entity closes a retail store, which is expected to result in a migration of customers to the website operations. The website sells the household goods previously sold through the closed retail store in addition to other products. The ongoing entity purchased and will continue to purchase the household goods from an unrelated wholesale distributor. The ongoing entity estimates that a migration of customers from the closed retail store to the website after the disposal transaction will result in the ongoing entity recognizing $50 thousand of sales related to such migration. The ongoing entity estimates that the component would have generated $250 thousand of sales absent the disposal transaction.

Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated by the ongoing entity from transactions with customers of the disposed component.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a migration, since customers are migrating from the closed retail store to the website, which sells products similar to those sold in the closed retail store. Therefore, an evaluation of the significance of the continuing cash flows must be performed.

Step 3: Are the continuing cash flows significant? Yes. The ongoing entity estimates that the continuing cash inflows will approximate 20 percent of the cash inflows that would have been incurred absent the disposal transaction. The ongoing entity believes that 20 percent is significant.

Conclusion: The continuing cash flows should be considered direct cash flows of the disposed component due to significant cash inflows that are expected to be generated by the ongoing entity as a result of a migration of customers from the closed retail store to the website. An evaluation of cash outflows is not necessary. Since the continuing cash flows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 3

An entity owns a commercial building that is being leased to third-party lessees. For that entity, the building is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the building is a component of the entity. The entity commits to a plan to sell the building. The building is classified as held for sale at that date. The ongoing entity will enter into a long-term management agreement with the buyer under which the ongoing entity will continue to manage the day-to-day operations of the building in exchange for a management fee at market rates.

The ongoing entity estimates that continuing cash inflows as a result of a continuation of activities (providing management services) will result in the ongoing entity recognizing $250 thousand of revenue. The ongoing entity estimates that the disposed component would have generated $5 million of rental revenue absent the disposal transaction. The ongoing entity estimates that after the disposal transaction, continuing cash outflows as a result of a continuation of activities (providing management services) between the ongoing entity and the disposed component will result in the ongoing entity recognizing $200 thousand of cash outflows. The ongoing entity estimates that the disposed component would have generated $1 million of cash outflows associated with owning and managing the building absent the disposal transaction.

Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated by the ongoing entity resulting from the management agreement.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a continuation of activities, since the ongoing entity provided management services, along with other services such as providing rental space, before the disposal transaction and will continue to provide management services to the disposed component after the disposal transaction. Therefore, an evaluation of the significance of the continuing cash flows must be performed.

Step 3: Are the continuing cash flows significant? Yes. The ongoing entity estimates that the continuing cash inflows will approximate 5 percent of the cash inflows that would have been generated by the disposed component. The ongoing entity does not believe this is significant. However, the continuing cash outflows will approximate 20 percent of the cash outflows that would have been generated by the disposed component. The ongoing entity believes that this is significant.

Conclusion: The continuing cash flows should be considered direct cash flows of the disposed component due to significant cash outflows that are expected to be generated by the ongoing entity as a result of a continuation of management activities between the ongoing entity and the disposed component after disposal. Since the continuing cash flows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 4

An entity owns an oil field that produces crude oil that is sold in an active market. For that entity, a field is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the field is a component of the entity. The entity commits to a plan to sell the oil field to a third-party buyer. The oil field is classified as held for sale at that date. The entity will bring another oil field online shortly after the sale in the same geographic region and expects to sell a similar amount and type of crude oil extracted from this new field as it did from the sold oil field to the same market. The ongoing entity will not have any involvement in the operations of the sold oil field after its disposal.

Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are expected to be generated from the sale of oil, since the ongoing entity will continue to sell a similar type of oil to the same market.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a migration, since there is a presumption that the ongoing entity continuing to sell a similar commodity in an active market after the disposal transaction would be considered a migration. This presumption may be overcome based on facts and circumstances. The new oil field is located in the same geographic region as the sold oil field and will be selling a similar type of crude oil to the same market. Therefore, the presumption that a migration has occurred cannot be overcome, and an evaluation of the significance of the continuing cash flows must be performed.

Step 3: Are the continuing cash flows significant? Yes. The ongoing entity will be selling a similar amount of crude oil from the new oil field and therefore estimates that the continuing cash inflows will approximate 100 percent of the cash inflows that would have been generated absent the disposal transaction. The ongoing entity believes that 100 percent is significant.

Conclusion: The continuing cash flows should be considered direct cash flows of the disposed component due to the significant cash inflows that are expected to be generated by the ongoing entity as a result of a migration of customers from the sold oil field to the new oil field. An evaluation of cash outflows is not necessary. Since the continuing cash flows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 5

An entity owns several commercial buildings that are being leased to third-party lessees. The buildings are of the same type and are located in the same geographic region. For that entity, the building is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each building is a component of the entity. The entity commits to a plan to sell one of the buildings. The building is classified as held for sale at that date.

The ongoing entity will purchase another commercial building in the same geographic region as the sold building. The ongoing entity does not anticipate that any lessees from the sold building will terminate their leases and migrate to the new building; however, the ongoing entity believes that certain lessees from the sold building will also be lessees in the new building. The seller provides the buyer financing in the form of a 5-year loan equal to 20 percent of the purchase price, which provides the seller with recourse to the buyer's assets. The loan bears a market rate of interest, the rights conveyed are customary for these types of loan agreements, and the buyer is considered to have high credit quality. The ongoing entity will not otherwise be involved in the operations of the disposed component.

Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Cash flows associated with the disposed component are being generated by the ongoing entity resulting from (1) leasing space in the new building to some of the same lessees of the old building and (2) interest income from the seller-provided financing.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? No. The continuing cash flows do not result in a migration, nor do they provide for a continuation of activities. Although the ongoing entity will lease space to some of the same lessees as the old building, the new building will not generate revenues or incur costs from specific customers who have migrated from the disposed component, since the lessees of the disposed component are not expected to terminate their leases and migrate to the new building. Additionally, there will not be any continuation of activities between the ongoing entity and the sold building. That is, the interest income recognized is from an activity that is different in nature from the activities of leasing and managing space in a building. Accordingly, an evaluation of the significance of the continuing cash flows is not necessary. An evaluation of continuing involvement should be performed.

Step 3: Does the ongoing entity have significant continuing involvement in the operations of the disposed component? No. The seller-provided financing likely will not result in the ongoing entity having the ability to significantly influence the operating and (or) financial policies of the disposed component after it is sold, based on the following:

a. The agreement is not significant to the overall operations of the disposed component, since the loan amount is equal to 20 percent of the purchase price, the loan is recourse to the buyer's assets, and the buyer is considered to have high credit quality.
b. The extent to which the ongoing entity is involved in the operations of the disposed component is limited to the loan agreement.
c. The rights conveyed by the loan agreement do not enable the ongoing entity to exert significant influence over the disposed component.

Conclusion: Since the continuing cash flows are considered indirect cash flows and the ongoing entity will not have significant continuing involvement in the operations of the disposed component, classification as a discontinued operation would be appropriate.

Example 6

An entity that manufactures sporting goods has a bicycle division that designs, manufactures, markets, and distributes bicycles to its company-owned retail stores as well as third-party retailers. For that entity, the bicycle manufacturing operation is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the manufacturing of the bicycles is a component of the entity.

The entity has experienced losses in its bicycle division resulting from an increase in manufacturing costs (principally, labor costs). The entity decides to remain in the bicycle business but will outsource the manufacturing operations and commits to a plan to sell the related manufacturing facility. The facility is classified as held for sale at that date. The entity will sell the manufacturing facility along with the third-party customer contracts and will enter into an outsourcing agreement with the buyer of that facility. The agreement will allow the ongoing entity to purchase 5 percent of the output from the facility at market rates for a period of 10 years, which will be sold through the company-owned store locations. The outsourcing agreement includes customary terms and does not permit the ongoing entity to be otherwise involved in the operations of the disposed component. The revenues generated from sales to company-owned store locations approximated 5 percent of the total revenues generated by the disposed component. The outsourcing agreement does not meet the definition of a lease based on an evaluation of the guidance in EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease."

There are no continuing cash inflows as a result of the continuation of activities, since no revenue will be generated by the ongoing entity as a direct result of the disposal transaction. The ongoing entity estimates that the continuing cash outflows as a result of a continuation of activities (the outsourcing arrangement) will result in the ongoing entity recognizing $50 thousand in costs to provide product for the company-owned retail stores. The ongoing entity estimates that the disposed component would have generated $1 million of costs to manufacture product for the third-party customers and the company-owned retail stores.

Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated by the ongoing entity resulting from the purchasing of manufactured product from the disposed component.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component, since the ongoing entity will purchase manufactured product from the disposed component. Therefore, an evaluation of the significance of the continuing cash flows should be performed.

Step 3: Are the continuing cash flows significant? No. The ongoing entity estimates that the continuing cash outflows will approximate 5 percent of the cash outflows that would have been generated by the disposed component. The ongoing entity believes that 5 percent is not significant.

Step 4: Does the ongoing entity have significant continuing involvement in the operations of the disposed component? No. The outsourcing agreement likely will not result in the ongoing entity having the ability to significantly influence the operating and (or) financial policies of the disposed component after it is sold based on the following:

a. The agreement is not significant to the overall operations of the disposed component, since the ongoing entity will be purchasing only 5 percent of the output from the facility.
b. The extent to which the ongoing entity is involved in the operations of the disposed component is limited to its ability to purchase bicycles for a period of 10 years.
c. The rights conveyed by the agreement do not enable the ongoing entity to exert significant influence over the disposed component.
d. The outsourcing agreement is priced at market rates.

Conclusion: Since the continuing cash flows are considered indirect cash flows and the ongoing entity will not have significant continuing involvement in the operations of the disposed component, classification as a discontinued operation would be appropriate.

Example 7

An entity manufactures and sells furniture through its company-owned and dealer-owned retail stores. These company-owned and dealer-owned stores also purchase furniture from third parties. For that entity, each of the company-owned retail stores is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each retail store is a component of the entity.

The entity has experienced losses in its company-owned store division resulting from an increase in costs associated with operating its retail stores (principally, labor and rental costs). The entity decides to remain in the furniture manufacturing business but will sell its retail operations to its dealers and commits to a plan to sell those retail stores. The retail stores are classified as held for sale at that date. The entity will sell the retail stores and will enter into a supply arrangement to supply furniture to the dealer-owned stores, which include the stores that were previously company-owned stores.

The entity estimates that continuing cash inflows as a result of a continuation of activities (selling furniture) will result in the ongoing entity recognizing $10 million of revenue from the sale of furniture to the dealers that have acquired the company-owned stores. The entity estimates that the disposed component would have generated $11 million from the sale of furniture through the company-owned retail stores.

Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated by the ongoing entity resulting from the sale of product to the disposed component.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component, since the ongoing entity will sell manufactured product to the disposed component. Therefore, an evaluation of the significance of the continuing cash flows should be performed.

Step 3: Are the continuing cash flows significant? Yes. The entity estimates that the continuing cash inflows will approximate 91 percent of the cash inflows that would have been generated by the component absent the disposal transaction. The entity believes that 91 percent is significant.

Conclusion: The continuing cash flows should be considered direct cash flows of the disposed component due to the significant cash inflows that are expected to be generated by the ongoing entity as a result of the sale of manufactured product to the disposed component. An evaluation of cash outflows is not necessary. Since the continuing cash flows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 8

An entity mines, refines, and smelts aluminum that is sold to third-party customers and used in the entity's fabrication business. For that entity, the manufacturing (which includes the mining, refining, and smelting operations) and fabrication businesses are the lowest levels at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the manufacturing and fabrication businesses each represent components of the entity.

The entity has experienced losses in its fabrication operation resulting from an increase in costs (principally, labor costs). The entity decides to remain in the aluminum manufacturing business but will sell its fabrication operation. The fabrication operation is classified as held for sale at that date. The entity will sell the fabrication business and will enter into a 5-year supply arrangement with the buyer to supply approximately 10 percent of the aluminum requirements to the disposed component at market rates. The terms of the supply agreement are customary, and the agreement does not provide the ongoing entity with the ability to otherwise be involved in the operations of the disposed component.

The entity estimates that continuing cash inflows as a result of a continuation of activities (selling aluminum) will result in the ongoing entity recognizing $300 thousand of revenue from the sale of aluminum to the disposed component. The entity estimates that the disposed component would have generated $10 million of revenue from the sale of fabricated aluminum to third-party customers absent the disposal transaction.

The entity estimates that continuing cash outflows as a result of a continuation of activities (selling aluminum) will result in the ongoing entity recognizing $250 thousand of costs associated with the production of the aluminum to be sold to the disposed component. The entity estimates that the disposed component would have generated $12 million of costs associated with the fabrication of aluminum to be sold to third-party customers absent the disposal transaction.

Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated by the ongoing entity resulting from the sale of product to the disposed component.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component, since the ongoing entity will sell aluminum to the disposed component. Although aluminum is considered a commodity, because the disposed component was not engaged in the sale of the commodity (that is, the disposed component sold fabricated aluminum products), the ongoing entity would not presume migration of the disposed component's customers to the ongoing entity. Therefore, an evaluation of the significance of the continuing cash flows should be performed.

Step 3: Are the continuing cash flows significant? No. The entity estimates that the continuing cash inflows will approximate 3 percent of the cash inflows and 2 percent of the cash outflows that would have been generated by the disposed component absent the disposal transaction. The entity believes that 3 percent and 2 percent are not significant.

Step 4: Does the ongoing entity have significant continuing involvement in the operations of the disposed component? The supply agreement likely will not result in the ongoing entity having the ability to significantly influence the operating and (or) financial policies of the disposed component after it is sold, based on the following:

a. The agreement is not significant to the overall operations of the disposed component, since the ongoing entity will be selling 10 percent of the disposed component's aluminum requirements.
b. The extent to which the ongoing entity is involved in the operations of the disposed component is limited to the ability to sell aluminum for a period of five years.
c. The rights conveyed by the agreement do not enable the ongoing entity to exert significant influence over the disposed component.
d. The agreement is at market.

Conclusion: Since the continuing cash flows are considered indirect cash flows and the ongoing entity will not have significant continuing involvement in the operations of the disposed component, classification as a discontinued operation would be appropriate.

Example 9

An entity is a manufacturer and distributor of medical devices. For that entity, the medical device operation is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the medical device operation is a component of the entity.

The entity sells the medical device operations to a third-party buyer. In conjunction with the sale, the ongoing entity and the buyer enter into a 5-year royalty agreement that provides the ongoing entity with the right to receive a royalty fee from the buyer equal to 10 percent of revenues generated from the sale of medical devices that were sold previously by the entity. The terms of the royalty agreement do not provide the ongoing entity with the ability to be otherwise involved in the operations of the disposed component.

Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated from the royalty arrangement.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? No. The royalty agreement provides for neither a migration nor a continuation of activities. The revenue-producing activities and cost-generating activities of the component before the disposal transaction were the manufacturing and sale of medical devices. The ongoing entity will not continue any of those activities after the disposal transaction; therefore, the cash flows associated with the royalty fee are indirect cash flows. Accordingly, an evaluation of the significance of the continuing cash flows is not necessary. An evaluation of continuing involvement should be performed.

Step 3: Does the ongoing entity have significant continuing involvement in the operations of the disposed component? The royalty arrangement would likely not provide the ongoing entity with the ability to significantly influence the operating and (or) financial policies of the disposed component based on the following:

a. The royalty agreement is not significant to the overall operations of the disposed component.
b. The extent to which the ongoing entity is involved in the operations of the disposed component is limited to the ability to receive a royalty payment.
c. The rights conveyed by the agreement do not enable the ongoing entity to exert significant influence over the disposed component.

Conclusion: Since the continuing cash flows are considered indirect cash flows and the ongoing entity will not have significant continuing involvement in the operations of the disposed component, classification as a discontinued operation would be appropriate.

Example 10

An entity that is a franchisor in the quick-service restaurant business also operates company-owned restaurants. For that entity, an individual company-owned restaurant is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each company-owned restaurant is a component of the entity.

Based on its evaluation of the ownership mix of its system-wide restaurants in certain markets, the entity commits to a plan to sell its company-owned restaurants in one region to an existing franchisee. The restaurants are classified as held for sale at that date. The ongoing entity will enter into a franchise agreement that will provide it with the right to sell product to the restaurants in addition to receiving franchise fees determined, in part, based on the future revenues of the restaurants. The entity estimates that the continuing cash inflows from the sale of product will approximate 20 percent of the cash inflows, while the franchise fee will approximate 5 percent of the cash inflows that would have been generated by the disposed component absent the disposal transaction.

Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows would be generated by the ongoing entity from the sale of product and the franchise fee.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component, since the ongoing entity will sell product to the disposed component and will provide franchise services to the disposed component. The ongoing entity sold product prior to the disposal transaction and performed services similar to franchise services on its own behalf prior to the disposal transaction. Therefore, an evaluation of the significance of the continuing cash flows should be performed.

Step 3: Are the continuing cash flows significant? Yes. The entity estimates that the continuing cash inflows will approximate 25 percent of the cash inflows that would have been generated by the disposed component absent the disposal transaction. The entity believes that 25 percent is significant.

Conclusion: The continuing cash flows should be considered direct cash flows of the disposed component due to the significant cash inflows that are expected to be generated by the ongoing entity as a result of the sale of product to the disposed component and the franchise fee. An evaluation of cash outflows is not necessary. Since the continuing cash flows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 11

An entity that is a franchisor in the quick-service restaurant business also operates company-owned restaurants. For that entity, an individual company-owned restaurant is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each company-owned restaurant is a component of the entity.

Based on its evaluation of the ownership mix of its system-wide restaurants in certain markets, the entity commits to a plan to sell its company-owned restaurants in one region to an existing franchisee. The restaurants are classified as held for sale at that date. The ongoing entity will enter into a franchise agreement that will provide it with the right to receive franchise fees determined, in part, based on the future revenues of the restaurants. The entity estimates that the continuing cash inflows from the franchise fee will approximate 5 percent of the cash inflows that would have been generated by the disposed component absent the disposal transaction.

Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated by the ongoing entity from the franchise agreement.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component, since the ongoing entity will provide franchise services to the disposed component. The ongoing entity performed services similar to the franchise services on its own behalf prior to the disposal transaction. Therefore, an evaluation of the significance of the continuing cash flows should be performed.

Step 3: Are the continuing cash flows significant? No. The entity estimates that the continuing cash inflows will approximate 5 percent of the cash inflows that would have been generated by the disposed component absent the disposal transaction. The entity believes that 5 percent is insignificant.

Step 4: Does the ongoing entity have significant continuing involvement in the operations of the disposed component? The franchise arrangement would likely constitute significant continuing involvement. Although the franchise agreement is only 5 percent of net sales, the ongoing entity is actively involved in the operations of the disposed component through the franchise agreement and, therefore, would have the ability to significantly influence the operating and (or) financial policies of the disposed component.

Conclusion: Although the continuing cash flows generated by the franchise agreement are indirect cash flows because they are not significant, the franchise agreement provides the ongoing entity with significant continuing involvement in the ongoing operations of the disposed component. Therefore, classification as a discontinued operation would not be appropriate.

Issue No. 04-5

Title: 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

Dates Discussed: June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004

References: FASB Statement No. 5, *Accounting for Contingencies*

FASB Statement No. 57, *Related Party Disclosures*

FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*

AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements*

APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*

APB Opinion No. 20, *Accounting Changes*

APB Opinion No. 29, *Accounting for Nonmonetary Transactions*

AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*

Introduction

1. For many years, financial statement preparers and auditors have debated how to evaluate whether a partnership should be consolidated by one of its partners. Recent guidance provided in Interpretation 46(R)[1] regarding kick-out rights in the context of evaluating variable interests and consolidation of variable interest entities has renewed the debate over what considerations are relevant in determining whether the general partner should consolidate a limited partnership. In practice today, the question of whether a partnership should be consolidated by one of its partners is typically addressed by analogizing to the guidance in SOP 78-9, which specifically provides guidance on the accounting for investments in real estate ventures, including investments in corporate joint ventures, general partnerships, limited partnerships, and undivided interests. Very little authoritative guidance exists for purposes of assessing whether a limited partner's rights are *important rights* that, under SOP 78-9, might preclude a general partner from consolidating a limited partnership. As a result, differing views in practice about what rights constitute important rights have evolved over time.

Issue

2. The issue is when a sole general partner should consolidate a limited partnership.

[1] Refer to paragraph B20 of Interpretation 46(R).

Prior EITF Discussion

3. At the June 30–July 1, 2004 EITF meeting, the Task Force discussed the general direction and approach for addressing which rights held by a limited partner(s) would preclude consolidation of a limited partnership by the sole general partner. The Task Force agreed that the framework developed by the Working Group for EITF Issue No. 98-6, "Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Approval or Veto Rights," is an appropriate starting point for this Issue, including the presumption that a sole general partner should consolidate a limited partnership absent certain rights held by the limited partner(s). A Task Force member noted that the scope of this Issue should be limited to those limited partnerships with a single general partner or limited partnerships with multiple general partners only if all the general partners are related parties. The Task Force provided the FASB staff with a general direction for developing this Issue.

4. At the September 29–30, 2004 EITF meeting, the Task Force discussed a proposed framework for addressing when a sole general partner should consolidate a limited partnership but did not reach a consensus. The proposed framework presumes that a sole general partner in a limited partnership controls the limited partnership and, therefore, should include the limited partnership in its consolidated financial statements. The presumption of control can be overcome if the limited partners have (a) the substantive ability to remove the sole general partner or otherwise dissolve the limited partnership or (b) substantive participating rights.

5. The Task Force generally agreed with the presumption of control by the sole general partner and that the presumption could be overcome if the limited partners have the ability to remove the sole general partner or otherwise dissolve the limited partnership. The Task Force also generally agreed that the evaluation of whether the rights to dissolve the partnership or remove the general partner are substantive should be consistent with the guidance in paragraph B20 of Interpretation 46(R).

6. The Task Force also discussed the evaluation of whether participating rights held by the limited partners would overcome the presumption of control by the sole general partner. The Task Force observed that there is an inconsistency between the important rights concept in SOP 78-9 and substantive participating rights in EITF Issue No. 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholders Have Certain Approval or Veto Rights." The Task Force directed the FASB staff to develop an approach to reconcile this inconsistency and to consider the protective rights concept in Issue 96-16. The Task Force acknowledged that such an approach may require a reconsideration of certain aspects of Issue 96-16 and SOP 78-9. The Task Force also directed the FASB staff to consider whether the nature of a limited partnership should be considered when evaluating whether a sole general partner should consolidate that entity. The Task Force also asked the FASB staff to consider whether there are substantive differences between corporations and partnerships that warrant different consolidation treatment by a general partner or majority owner with respect to the rights of limited partners or minority owners.

Current EITF Discussion

7. At the November 17–18, 2004 EITF meeting, the Task Force reached a tentative conclusion on a framework for addressing when a sole general partner should consolidate a limited partnership. The proposed framework presumes that a sole general partner in a limited partnership controls the limited partnership and, therefore, should include the limited partnership in its consolidated financial statements. The presumption of control is overcome if the limited partners have (a) the substantive ability to remove the sole general partner or otherwise dissolve the limited partnership or (b) substantive participating rights. The Task Force agreed that the substantive participating rights that overcome the presumption of control should be consistent with the substantive participating rights described in Issue 96-16. The Task Force further agreed that the "Factors to Consider" in Issue 96-16, which are used in evaluating participating rights, along with the examples, should also be included in this Issue's proposed framework. The Task Force tentatively agreed to add additional guidance for evaluating whether participating rights that can be exercised by a vote of the limited partners or a vote of the limited partners and the sole general partner are substantive. With that exception, the "Factors to Consider" section of the proposed framework will be consistent with Issue 96-16. The framework that reflects the tentative conclusions reached by the Task Force is included in the draft abstract attached as Appendix 04-5A.

8. The Task Force also reached a tentative conclusion that any consensus, upon ratification by the Board, would be effective for all new limited partnership agreements and for limited partnership agreements that are modified subsequent to the date of ratification, and that the application of one of the two transition methods described in Issue 96-16 would be acceptable for existing limited partnerships. That tentative conclusion is included under "Transition" in the attached draft abstract.

9. The Task Force asked the FASB staff to post the draft abstract to the FASB website for public comment. Comments will be considered by the Task Force at the March 16–17, 2005 EITF meeting. Further, the Task Force asked the FASB staff to include in the request for comment accompanying the draft abstract a question that asks constituents if guidance similar to that in the draft abstract should be provided for evaluating whether participating rights that can be exercised by a vote of the minority shareholders are substantive for corporate entities. The Task Force will consider the comments from constituents when evaluating whether that additional guidance for corporate entities should be added to the guidance in Issue 96-16.

10. Further, the Task Force acknowledged that the tentative conclusions reached in this Issue conflict with certain aspects of SOP 78-9. The Task Force generally agreed that the accounting for limited partnership investments by a sole general partner should be consistent for all limited partnerships, irrespective of the industry within which the limited partnership operates. Accordingly, the Task Force requested that the Board consider amending the guidance in SOP 78-9 to be consistent with the tentative conclusions reached in this Issue.

11. The draft abstract will be posted to the FASB website for comment. At its November 30, 2004 meeting, the Board agreed to propose an amendment to certain provisions of SOP 78-9 in anticipation of an EITF consensus that is consistent with the current tentative conclusions in this Issue. The staff will post the proposed amendment to SOP 78-9 to the FASB website for

comment in conjunction with the posting of the draft abstract for this Issue. The Board indicated that it will consider the outcome of the Task Force's deliberations and the related comments received from constituents before finalizing an amendment to SOP 78-9.

Status

12. Further discussion is expected at a future meeting.

Appendix 04-5A

***EITF Abstracts* (DRAFT[2])**

Issue No. 04-5

Title: 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

Dates Discussed: June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004

References: FASB Statement No. 5, *Accounting for Contingencies*

FASB Statement No. 57, *Related Party Disclosures*

FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*

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APB Opinion No. 29, *Accounting for Nonmonetary Transactions*

AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*

ISSUE

1. For many years, financial statement preparers and auditors have debated how to evaluate whether a partnership should be consolidated by one of its partners. Recent guidance provided in Interpretation 46(R)[3] regarding "kick-out" rights in the context of evaluating variable interests and consolidation of variable interest entities has renewed the debate over what considerations are relevant in determining whether the general partner should consolidate a limited partnership. In practice today, the question of whether a partnership should be consolidated by one of its partners is typically addressed by analogizing to the guidance in SOP 78-9, which specifically provides guidance on the accounting for investments in real estate ventures, including

[2] This draft abstract was prepared to facilitate discussion of the guidance on which the Task Force reached its tentative conclusions and contains all substantive aspects of the tentative conclusions.
[3] Refer to paragraph B20 of Interpretation 46(R).

investments in corporate joint ventures, general partnerships, limited partnerships, and undivided interests. Very little authoritative guidance exists for purposes of assessing whether a limited partner's rights are *important rights* that, under SOP 78-9, might preclude a general partner from consolidating a limited partnership. As a result, differing views in practice about what rights constitute important rights have evolved over time.

2. The issue is when a sole general partner should consolidate a limited partnership.

Scope

3. The scope of this Issue is limited to investments in which the investor is the sole general partner in a limited partnership or similar entity (such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership) and the limited partnership is not a variable interest entity under Interpretation 46(R). For purposes of this Issue, a *sole general partner* is a single investor or a single investor and its related parties that own all of the general partnership interests in a limited partnership being considered for consolidation. The investor's related parties are those parties defined as related parties in Statement 57. This Issue does not apply to general partners that, in accordance with generally accepted accounting principles, carry substantially all of their assets, including investments in controlled entities, at fair value with changes in fair value reported in a statement of operations or financial performance. This Issue also is not intended to change current guidance in Issue No. 00-1, "Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures," on when it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership.

EITF DISCUSSION

4. The Task Force reached a consensus that a sole general partner in a limited partnership should determine whether it should consolidate its investment in a limited partnership based upon the application of the following framework:

Presumption of Control

5. A sole general partner in a limited partnership is presumed to control that limited partnership and therefore should include the limited partnership in its consolidated financial statements, regardless of the sole general partner's ownership interest in the limited partnership.[4] The assessment of whether the rights of the limited partners[5] should overcome the presumption of control, and therefore consolidation, by the sole general partner is a matter of judgment that depends on facts and circumstances. Such facts and circumstances should be evaluated based on the following two-step process:

Step 1: Do the limited partners have the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the sole general partner without cause?[6]

6. For purposes of this Issue, the limited partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the sole general partner are collectively referred to as kick-out rights. Determination of whether the kick-out rights are substantive should be based on a consideration of all relevant facts and circumstances. Substantive kick-out rights must have both of the following characteristics:

a. The kick-out rights can be exercised by a vote of no more than a simple majority of the voting interests held by parties other than the sole general partner or by a vote of a single limited partner and its related parties.

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[4] Refer to the guidance included under "Factors to Consider" on how the ownership interest should be considered when evaluating whether participating rights overcome the presumption of control.

[5] The term *limited partners* refers to one or more limited partners and shall have this meaning when used in the context of this Issue.

[6] W*ithout cause* means that no reason need be given for the dissolution (liquidation) of the limited partnership or removal of the general partner. *With cause* generally restricts the limited partners' ability to dissolve (liquidate) the limited partnership or remove the general partner in situations that include, but that would not be limited to, fraud, illegal acts, gross negligence, and bankruptcy of the general partner. Dissolution (liquidation) of the partnership or removal of the general partner due solely to poor performance of the general partner should be considered "without cause" for the purposes of this Issue. For example, if the limited partners can exercise their kick-out rights only when the limited partnership does not achieve specified performance targets, the kick-out rights may overcome the presumption of control.

b. The limited partners holding the kick-out rights have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights. Barriers include, but are not limited to:

(1) Kick-out rights subject to conditions that make it unlikely they will be exercisable; for example, conditions that narrowly limit the timing of the exercise

(2) Financial penalties or operational barriers associated with dissolving (liquidating) the limited partnership or replacing the sole general partner that would act as a significant disincentive for dissolution (liquidation) or removal

(3) The absence of an adequate number of qualified replacement general partners or inadequate compensation to attract a qualified replacement

(4) The absence of an explicit, reasonable mechanism in the limited partnership agreement or in the applicable laws or regulations, by which the limited partners holding the rights can call for and conduct a vote to exercise those rights

(5) The inability of the limited partners holding the rights to obtain the information necessary to exercise them.

7. For purposes of applying Step 1, the limited partners' unilateral right to withdraw from the partnership in whole or in part without incurring a significant economic penalty (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership would not overcome the presumption that the sole general partner controls the limited partnership (that is, the withdrawal right is not deemed to be a kick-out right).

8. If, based on the preceding evaluation, the limited partners possess substantive kick-out rights, presumption of control by the sole general partner, and therefore consolidation, would be overcome. The sole general partner should account for its investment in the limited partnership using the equity method of accounting.

9. If the limited partners do not possess substantive kick-out rights, proceed to Step 2.

Step 2: Do the limited partners have substantive participating rights?

10. If the limited partners have substantive participating rights, the presumption of control by the sole general partner would be overcome and, therefore, the sole general partner should account for its investment in the limited partnership using the equity method of accounting. Substantive participating rights provide the limited partners with the ability to effectively participate in significant decisions that would be expected to be made in the ordinary course of the limited partnership's business.

11. The Task Force agreed that "participating rights" are different from "protective rights." All limited partners' rights could be described as "protective rights," but some rights also allow the limited partners to participate in certain financial and operating decisions of the limited partnership that are made in the ordinary course of business (referred to as participating rights). The Task Force agreed that limited partners' rights that are only protective in nature (referred to as "protective rights") do not overcome the presumption that the sole general partner controls, and therefore should consolidate, the limited partnership. The Task Force agreed that limited partners' rights that provide the limited partners with the right to effectively participate in significant decisions that would be expected to be made in the ordinary course of the limited partnership's business while being protective of the limited partners' investment overcome the presumption that the sole general partner controls the limited partnership. Therefore, the sole general partner should not consolidate the limited partnership.

12. For purposes of applying this framework, decisions made in the ordinary course of business are defined as decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out the limited partnership's current business activities, regardless of whether the events or transactions that would necessitate such decisions are expected to occur in the near term. However, it must be at least reasonably possible that those events or transactions that would necessitate such decisions will occur. Ordinary course of business does not include self-dealing transactions with a sole general partner.

13. In applying Step 2 of the framework, the Task Force reached a consensus that the following

guidance should be considered in evaluating whether rights held by the limited partners overcome the presumption of control by the sole general partner.

Protective Rights

14. The Task Force believes that limited partners' rights (whether granted by contract or by law) that would allow the limited partners to block the following limited partnership actions would be considered protective rights and would not overcome the presumption of control, and therefore consolidation, by the sole general partner.

a. Amendments to the limited partnership agreement
b. Pricing on transactions between the sole general partner and the limited partnership and related self-dealing transactions
c. Liquidation of the limited partnership initiated by the sole general partner or a decision to cause the limited partnership to enter bankruptcy or other receivership
d. Acquisitions and dispositions of assets greater than 20 percent of the fair value of the limited partnership's total assets (limited partners' rights relating to acquisitions and dispositions of 20 percent or less do not necessarily lead to the conclusion that it is a substantive participating right—see "Factors to Consider" and Exhibit 04-5A)
e. Issuance or repurchase of limited partnership interests.

15. The Task Force considered the above to be illustrative of some but not all of the protective rights that often are provided to limited partners.

Substantive Participating Rights

16. The Task Force believes that limited partners' rights (whether granted by contract or by law) that would allow limited partners to effectively participate in the following actions of the limited partnership should be considered substantive participating rights and would overcome the presumption that the sole general partner controls the limited partnership:

a. Selecting, terminating, and setting the compensation of management responsible for implementing the limited partnership's policies and procedures

b. Establishing operating and capital decisions of the limited partnership, including budgets, in the ordinary course of business.

17. The Task Force believes that in evaluating the limited partners' rights to determine whether or not they are substantive "participation" means the ability of the limited partners to approve or block actions proposed by the sole general partner. That is, the sole general partner must have the limited partners' agreement to take the actions outlined above in order for the rights to be substantive participating rights. Participation does not require the ability of the limited partners to initiate actions.

18. The Task Force considered the rights described in paragraph 16 to be illustrative of substantive participating rights, but not necessarily an all-inclusive list. The Task Force believes that the rights noted above are participating rights because, in the aggregate, the rights allow the limited partners to effectively participate in the decisions that occur as part of the ordinary course of the limited partnership's business and are significant factors in directing and carrying out the activities of the limited partnership. Individual rights, such as the right to veto the termination of management responsible for implementing the limited partnership's policies and procedures (if management is outsourced—via contract with a third party—by the sole general partner), should be assessed based on the facts and circumstances to determine if they are substantive participating rights in and of themselves. However, limited partners' rights that appear to be participating rights but that by themselves are not substantive (see "Factors to Consider" and Exhibit 04-5A) would not overcome the presumption of control, and therefore consolidation, by the sole general partner in the limited partnership. The likelihood that the veto right will be exercised by the limited partners should not be considered when assessing whether a limited partner right is a substantive participating right.

Factors to Consider

19. The Task Force agreed that the following factors should be considered in evaluating whether limited partners' rights that appear to be participating are substantive rights—that is, whether these factors provide for effective participation in significant decisions related to the limited partnership's ordinary course of business:

a. Consideration should be given to situations in which the sole general partner owns such a significant portion of the limited partnership that the limited partners have a small economic interest. The Task Force believes that as the disparity between the ownership interest of the sole general partner and the limited partners increases, the rights of the limited partners are presumptively more likely to be protective rights and should raise the level of skepticism about the substance of the right. Similarly, although the general partner is presumed to control the limited partnership, the level of skepticism about such ability should increase as the sole general partner's economic interest in the limited partnership decreases.

b. The limited partnership agreement needs to be considered to determine at what level decisions are made—by the sole general partner or by the limited partnership as a whole—and the rights at each level also should be considered. In all situations, any matters that can be put to a vote of the limited partnership must be considered to determine if the limited partners, individually or in the aggregate, have substantive participating rights by virtue of their ability to vote on matters submitted to a vote of the limited partnership. Determination of whether matters that can be put to a vote of the limited partners, or the vote of the limited partners and the sole general partner, are substantive should be based on a consideration of all relevant facts and circumstances. Rights that can be exercised by the limited partners' voting ability must have both of the following characteristics:

    (1) If only a vote of the limited partners is required, then that right can be exercised by the vote of no more than a simple majority of the voting interests held by parties other than the sole general partner or by the vote of a single limited partner and its related parties. If exercise of the right is dependent upon the total votes of both the limited partners and the sole general partner, then the voting interests held by the sole general partner must also be considered to determine if the limited partners' rights related to voting are substantive.

    (2) The limited partners holding the rights have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to exercise of the rights. Barriers include, but are not limited to:

(a) Conditions to which the rights are subject make it unlikely they will be exercisable; for example, conditions that narrowly limit the timing of the exercise

(b) Financial penalties or operational barriers associated with exercising the rights that would act as a significant disincentive for exercising the rights

(c) The absence of an explicit, reasonable mechanism in the limited partnership agreement or in the applicable laws or regulations, by which the limited partners holding the rights can call for and conduct a vote to exercise those rights

(d) The inability of the limited partners holding the rights to obtain the information necessary to exercise them.

c. Relationships between the sole general partner and the limited partners (other than investment in the common limited partnership) that are of a related-party nature, as defined in Statement 57, should be considered in determining if the participating rights of the limited partners are substantive. For example, if the limited partner in a limited partnership is a member of the immediate family of the sole general partner of the limited partnership, then the rights of the limited partner likely would not overcome the presumption of control, and therefore consolidation, by the sole general partner.

d. Certain limited partners' rights may deal with operating or capital decisions that are not significant to the ordinary course of business of the limited partnership. The Task Force concluded that limited partners' rights related to items that are not considered significant for directing and carrying out the activities of the limited partnership's business are not substantive participating rights and would not overcome the presumption of control, and therefore consolidation, by the sole general partner. Examples of such limited partners' rights relate to decisions about location of the limited partnership's headquarters, name of the limited partnership, selection of auditors, and selection of accounting principles for purposes of separate reporting of the limited partnership's operations.

e. Certain limited partners' rights may provide for the limited partners to participate in significant decisions that would be expected to be made in certain business activities in the "ordinary course of business"; however, the Task Force concluded that the existence of such limited partners' rights should not overcome the presumption that the sole general partner should consolidate if it is remote[7] that the event or transaction that requires the limited partners' approval will occur.

f. A sole general partner who has a contractual right to buy out the interest of the limited partners in the limited partnership for fair value or less should consider the feasibility of exercising that contractual right when determining if the participating rights of the limited partners are substantive. If such a buyout is prudent, feasible, and substantially within the control of the sole general partner, the sole general partner's contractual right to buy out the limited partners demonstrates that the participating right of the limited partners is not a substantive right. The existence of such call options, for purposes of this Issue, negate the participating rights of the limited partners to approve or veto an action of the sole general partner rather than create an additional ownership interest for the sole general partner. It would not be "prudent, feasible, and substantially within the control of the sole general partner" to buy out the limited partners if, for example, (a) the limited partners control technology that is critical to the limited partnership or (b) the limited partners are the principal source of funding for the limited partnership.

20. The examples in Exhibit 04-5A are presented to illustrate how to assess individual limited partners' rights under the consensus in this Issue.

Initial Assessment and Reassessment of Limited Partners' Rights

21. The assessment of limited partners' rights and their impact on the presumption of control of the limited partnership by the sole general partner should be made when an investor becomes the sole general partner and should be reassessed if (a) there is a change to the terms or in the exercisability of the rights of the limited partners, (b) the sole general partner increases or decreases its ownership of limited partnership interests, or (c) there is an increase or decrease in the number of outstanding limited partnership interests.

[7] *Remote* is defined in Statement 5 as "the chance of the future event or events occurring is slight."

Transition

22. The Task Force reached a consensus that for sole general partners of all new limited partnerships formed and for existing limited partnerships for which the partnership agreements are modified, the guidance in this Issue is effective after [March 30, 2005] [the date of Board ratification]. The Task Force also reached a consensus that for sole general partners in all other limited partnerships, the guidance in this Issue is effective no later than for fiscal years beginning after December 15, 2005, and that application of either Transition Method A or Transition Method B, described below, would be acceptable.

Transition Method A

23. For existing limited partnership agreements that have not been modified, the guidance should be applied in financial statements issued for fiscal years beginning after December 15, 2005. Earlier application is encouraged. Thus, for a public company with a fiscal year ending on December 31, the guidance must be applied no later than the first quarter of 2006 based on agreements in effect at the time of adoption. If earlier application is chosen and the guidance is applied during an interim period other than the first interim period of the year of change, all prior interim periods of that fiscal year should be restated.

24. The effect of initially applying this guidance for existing limited partnership agreements should be accounted for similar to a change in accounting principle in accordance with paragraph 19(a)-(c) of Opinion 20. Thus, financial statements for prior years should be presented as previously reported, and the cumulative effect, if any, of adopting the guidance on the amount of retained earnings at the beginning of the period in which this guidance is first applied should be included in the net income of the period of the change. The effect on the opening balance sheet of adopting the new accounting principle should be disclosed in the year of adoption. Disclosure of the pro forma effects of application on net income is not required.

25. Generally, a change in accounting for a sole general partner's interest in a limited partnership from the equity method of accounting to consolidation or a change from consolidation to the equity method would not result in an adjustment to previously reported

equity or net income. However, a change from the equity method to consolidation could result in a cumulative effect adjustment if losses that would not have been recognized under the equity method are required to be recognized in consolidation or vice versa (see paragraph 15 of ARB 51, and paragraph 19(i) of Opinion 18). Other items that would have been accounted for differently in prior financial statements if this guidance had been applied *should not be adjusted*.[8]

Transition Method B

26. Alternatively, for existing limited partnership agreements that have not been modified, this guidance may be applied retroactively for fiscal years beginning after December 15, 2005 (earlier application is encouraged), by restating the financial statements of prior periods in accordance with the provisions of paragraphs 27–30, 34, and 35 of Opinion 20. If an entity applies this guidance retroactively, it should apply it to all existing limited partnership agreements based on the facts and circumstances at the time each investment was made and consider changes made in later periods. Other items that would have been accounted for differently in prior financial statements if this guidance had been applied *should be adjusted* in the financial statements under Transition Method B. Under Transition Method B, retroactive application is not required for investments in limited partnerships for which the entity is no longer the sole general partner as of the date that the guidance in this consensus is adopted.

Board Ratification

27. At its [March 30, 2005] meeting, the Board ratified the consensus reached by the Task Force in this Issue.

STATUS

28. No further EITF discussion is planned.

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[8] For example, an exchange of securities accounted for based on recorded amounts, under the presumption that control had not been obtained (refer to paragraph 21 of Opinion 29, and EITF Issue No. 01-2, "Interpretations of APB Opinion No. 29"), would not be adjusted to reflect the original exchange as a business combination even if application of the guidance in this Issue suggests that one party had obtained control. In addition, previously recorded intercompany profit elimination entries would not be revised to reflect the impact had an investment been consolidated rather than accounted for under the equity method or vice versa.

Exhibit 04-5A

EXAMPLES OF HOW TO ASSESS INDIVIDUAL LIMITED PARTNERS' RIGHTS UNDER ISSUE 04-5

The Task Force agreed that the following examples would facilitate the understanding of how to assess whether the rights of the limited partners should be considered protective or participating and, if participating, whether the rights are substantive. Although these examples illustrate the possible assessments of individual limited partners' rights, the evaluation of limited partners' rights should consider all of the factors identified in "Factors to Consider" to determine whether the limited partners' rights, individually or in the aggregate, provide for the limited partners to effectively participate in significant decisions that would be expected to be made in the "ordinary course of business."

Example 1

The rights of the limited partners relating to the approval of acquisitions and dispositions of assets that are 20 percent or less of the fair value of the limited partnership's total assets and that are closely related to the limited partnership's existing business (that is, same line of business) may be substantive participating rights. Rights related only to acquisitions that are not closely related to the limited partnership's existing business usually are protective and would not overcome the presumption of consolidation by the sole general partner in the limited partnership. In addition, if approval by the limited partners is necessary to incur additional indebtedness to finance an acquisition that is not in the limited partnership's ordinary course of business (that is, an acquisition greater than 20 percent of the fair value of the limited partnership's total assets or an acquisition of an investee that is not in the same line of business), then the approval by the limited partners would be considered a protective right.

Example 2

Existing facts and circumstances should be considered in assessing whether the rights of the limited partners relating to a limited partnership incurring additional indebtedness are protective or participating rights. For example, if it is reasonably possible or probable that the limited partnership will need to incur the level of borrowing that requires limited partner approval in its ordinary course of business, the rights of the limited partners would be viewed as substantive participating rights.

Example 3

The rights of the limited partners relating to dividends or other distributions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, rights to block customary or expected dividends or other distributions may be substantive participating rights, while rights to block extraordinary distributions would be protective rights.

Example 4

The rights of the limited partners relating to a limited partnership's specific action (for example, to lease property) in an existing business may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if the limited partnership had the ability to purchase, rather than lease, the property without requiring the approval of the limited partners, then the rights of the limited partners to block the limited partnership from entering into a lease would not be substantive.

Example 5

The rights of the limited partners relating to a limited partnership's negotiation of collective-bargaining agreements with unions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if a limited partnership does not have a collective-bargaining agreement with a union or if the union does not represent a substantial portion of the limited partnerships' work force, then the rights of the limited partners to approve or veto a new or broader collective-bargaining agreement are not substantive.

Example 6

Provisions that govern what will occur if the limited partners block the action of a sole general partner need to be considered to determine whether the right of the limited partners to block has substance. For example, if (a) the limited partnership agreement provides that if the limited partners block the approval of an operating budget, then the budget simply defaults to last year's budget adjusted for inflation and (b) the limited partnership operates in a mature business for which year-to-year operating budgets would not be expected to vary significantly, then the rights of the limited partners to block the approval of the operating budget does not allow the limited partners to effectively participate and are not substantive.

Example 7

Limited partners' rights relating to the initiation or resolution of a lawsuit may be considered protective or participating depending on the available facts and circumstances. For example, if lawsuits are a part of, or are expected to be a part of, the limited partnership's ordinary course of business, as is the case for some insurance entities, then the limited partners' rights may be considered a substantive participating right.

Example 8

The limited partners have the right to veto the annual operating budget for the first X years of the limited partnership. Based on the facts and circumstances, during the first X years of the limited partnership this right may be a substantive participating right. However, following Year X there is a significant change in the exercisability of the limited partners' rights (for example, the veto right terminates). As of the beginning of the period following Year X, since that right no longer exists, the presumption that the sole general partner controls and, therefore, should consolidate the partnership would not be overcome.

Issue No. 04-6

Title: Accounting for Stripping Costs in the Mining Industry

Dates Discussed: June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004

References: FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*

FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*

FASB Concepts Statement No. 6, *Elements of Financial Statements*

AICPA Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 4, "Inventory Pricing"

APB Opinion No. 20, *Accounting Changes*

Securities Act Industry Guide 7, *Description of Property by Issuers Engaged or to Be Engaged in Significant Mining Operations*

International Accounting Standards Exposure Draft 6, *Exploration and Evaluation of Mineral Resources*

International Accounting Standards Committee, *An Issues Paper Issued for Comment by the IASC Steering Committee on Extractive Industries*

Introduction

1. In the mining industry, companies may be required to remove overburden and other mine waste materials to access mineral deposits. The costs of removing overburden and waste materials are referred to as "stripping costs." During the development of a mine (before production begins), it is generally accepted in practice that stripping costs are capitalized as part of the depreciable cost of building, developing, and constructing the mine. Those capitalized costs are typically amortized over the productive life of the mine using the units of production method. A mining company may continue to remove overburden and waste materials, and therefore incur stripping costs, during the production phase of the mine. Questions have been raised about the appropriate accounting for stripping costs incurred during the production phase, and diversity in practice exists.

Scope

2. This Issue applies to mining entities. Mining entities include entities involved in finding and removing wasting natural resources, other than oil- and gas-producing entities that are within the scope of Statement 19.

Definition of the Production Phase

3. For purposes of this Issue, the definition of the production phase of a mine is as follows:

The production phase of a mine is deemed to have begun when operations have commenced and revenue is realized from the sale of minerals, irrespective of the level of production.

Issue

4. The issue is how stripping costs in the mining industry should be accounted for.

Prior EITF Discussion

5. At the June 30–July 1, 2004 EITF meeting, the Task Force discussed the accounting for stripping costs incurred during production but did not reach a consensus. The Task Force asked the FASB staff to further explore and develop with the Mining Industry Working Group the following alternatives for accounting for stripping costs: (a) expense as incurred, (b) defer as an asset (no liability recognition) and recognize in earnings using a proportional performance ratio, and (c) include in inventory as a variable production cost. The Task Force also requested the FASB staff to solicit a recommendation from the Working Group.

6. At the September 29–30, 2004 EITF meeting, the Task Force discussed the accounting for stripping costs incurred during production but did not reach a consensus. The Task Force considered the recommendation of the Working Group that stripping costs incurred during production are a mine development cost that should be capitalized as an investment in the mine and attributed to the proven and probable reserves benefited in a systematic and rational manner. A majority of the Task Force members expressed support for the Working Group recommendation; however, the Task Force directed the FASB staff to develop additional guidance about what constitutes a systematic and rational manner of attributing the capitalized costs to proven and probable reserves benefited. Additionally, the Task Force generally agreed that the attribution of stripping costs incurred in the pre-production phase of the mine should be the same as those incurred during the production phase. Accordingly, the scope of this Issue has been expanded to address the accounting for all stripping costs in the mining industry—both pre-production and production stripping costs.

Current EITF Discussion

7. At the November 17–18, 2004 EITF meeting, the Task Force generally agreed that stripping costs are mine development costs that should be capitalized as an investment in the mine to the extent that the stripping costs are expected to provide additional future benefit. Additionally, capitalized stripping costs should be attributed to proved and probable reserves in a systematic and rational manner.

8. The Task Force also generally agreed that an enterprise should specifically attribute stripping costs to reserves that directly benefit from the stripping activities. That is, if the reserves in the mine are sufficiently distinct from one another (for example, the mine has multiple ore bodies) such that stripping activities benefit the distinct reserves, the enterprise should attribute the related capitalized stripping costs to the specific reserves benefited. The Task Force generally agreed that both the units of production method and a proportional performance ratio (such as a stripping ratio) may be systematic and rational methods to attribute capitalized costs to reserves benefited. However, in no circumstances should an entity recognize

a liability (or accumulated amortization in excess of cumulative capitalized stripping costs) that results from the application of a proportional performance ratio. The Task Force also generally agreed that estimates used to apply those methods should be reevaluated at least on an annual basis or more frequently if there are changes in facts and circumstances. The Task Force also observed that amortization of stripping costs should be included in the cost of inventory when the costs are attributed to reserves that are extracted.

9. The Task Force asked the FASB staff to further explore whether there are factors that an entity should consider when determining the appropriate attribution method and to determine whether the attribution method should be an accounting policy decision or based on the facts and circumstances associated with the mine.

10. The SEC Observer expressed concern over the absence of specific guidance associated with the capitalization of stripping costs as mine development costs and the related attribution of those costs to inventory. However, the SEC Observer agreed to consult further with the SEC staff before concluding on the Issue.

Status

11. Further discussion is expected at a future meeting.

Issue No. 04-7

Title: Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity

Dates Discussed: June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004

References: FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*

FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*

AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements*

Introduction

1. Interpretation 46(R) provides guidance on how to apply the controlling financial interest criteria in ARB 51 to variable interest entities (VIEs). VIEs are evaluated for consolidation based on all contractual, ownership, or other interests that expose their holders to the expected losses or the expected residual returns of the entity. Those interests are termed variable interests. An integral part of applying Interpretation 46(R) is determining which pecuniary interests are variable interests.

2. Paragraph 2(c) of Interpretation 46(R) defines variable interests as "…contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets exclusive of variable interests." Paragraph B4 of Interpretation 46(R) describes what should be considered when determining whether an interest is a variable interest as follows:

> The identification of variable interests involves determining which assets, liabilities, or contracts create the entity's variability and which assets, liabilities, equity, and other contracts absorb or receive that variability. The latter are the entity's variable interests. The labeling of an item as an asset, liability, equity, or as a contractual arrangement does not determine whether that item is a variable interest. It is the role of the item—to absorb or receive the entity's variability—that distinguishes a variable interest. That role, in turn, often depends on the design of the entity.

3. An entity's variability is the sum of the absolute values of the expected losses and expected residual returns. Expected losses and expected residual returns are derived from expected cash flows of the entity. However, expected losses and expected residual returns refer to amounts discounted and adjusted for market factors and assumptions rather than to undiscounted cash flow estimates.

4. Constituents have raised concerns that Interpretation 46(R) is unclear as to how a reporting enterprise should determine whether a contract absorbs variability of an entity's net assets exclusive of variable interests; that is, whether the contract should be considered a variable interest. Different approaches for making that determination have been developed and used, which has resulted in inconsistent identification of certain interests as variable interests. Those inconsistencies can have a significant impact on the determination as to what the expected losses of the entity are, whether the entity is a VIE, and, ultimately, which party, if any, should consolidate the VIE.

5. There is diversity in practice regarding the methods used to determine whether an interest absorbs variability of an entity's net assets exclusive of variable interests. The following are four potential approaches for determining whether an interest is a variable interest:

a. *Fair value approach*—the determination is based on whether the interest absorbs variability in the fair value of the entity's net assets (exclusive of variable interests).
b. *Cash flow approach*—the determination is based on whether the interest absorbs variability in the cash flows of the entity's net assets (exclusive of variable interests).
c. *Combination approach*—the determination is based on whether the interest absorbs variability in either the cash flows or the fair value of the entity's net assets (exclusive of variable interests).
d. *By design approach*—the determination is based on the role of the interest; that is, whether it is used to absorb variability of the entity's net assets (exclusive of variable interests). In making this determination, many factors are considered, such as the role of each interest holder, the design of the VIE, the expectations of the interest holders, and the manner in which the VIE was marketed to the interest holders.

6. The FASB staff observed that in determining whether an interest creates or absorbs variability of the VIE's net assets exclusive of variable interests, issues have arisen on the difference between (a) assets that are physically held/owned by the VIE and (b) positions that are created by derivative and nonderivative forward contracts (referred to as "forward contracts") and that have economic profiles that are similar to owning the assets. When analyzing forward contracts pursuant to the guidance provided by paragraphs B12 and B13 of Interpretation 46(R), different conclusions can be reached as to whether a forward contract is a variable interest if one considers synthetically created positions to be assets similar to the assets created by cash transactions. A contract that creates a similar economic profile to the actual ownership of an asset is commonly referred to as a synthetic asset. A long position in an asset has the economic profile of owning the asset and is created by either purchasing the asset through a cash transaction or synthetically creating the asset through the use of a derivative instrument (for example, a forward to purchase the asset). A conclusion that a contract that synthetically creates a long position in an asset is similar to owning an asset would lead to the conclusion that the synthetic asset creates risks that are similar to owning an asset and therefore would likely not be a variable interest before consideration of the counterparty's credit and performance risk. That issue should be addressed when determining whether an interest is a variable interest and it should be addressed separately from the issue of what variability should be considered when making that determination.

Issues

7. The issues are:

Issue 1— What aspects or components of the variability in an entity's net assets (exclusive of variable interests) should be considered when determining whether an interest is a variable interest

Issue 2— When determining whether an interest is a variable interest, whether long positions of a VIE that are synthetically created by derivative transactions should be considered in the same manner as long positions created by cash transactions.

Prior EITF Discussion

8. At the June 30–July 1, 2004 EITF meeting, the Task Force discussed the four potential approaches described in paragraph 5, above, and some of the attributes inherent in those approaches. During the discussion, a fifth approach that incorporates the attributes of the combination approach and the by-design approach was introduced. The Task Force was not asked to reach a consensus on Issue 1. The Task Force asked the FASB staff and the Working Group to further develop the fifth approach and to include examples for each of the five potential approaches for discussion at a future meeting.

9. At the September 29–30, 2004 EITF meeting, FASB staff presented an approach developed by the FASB staff and the Working Group that would first require the determination of the type of variability that needs to be considered: (a) the fair value variability, (b) the cash flow variability, or (c) both the fair value variability and the cash flow variability. The FASB staff observed that although an interest may be absorbing the variability of a variable interest entity using any of the three approaches, many enterprises do not consider such interests to be variable interests because the interest was not designed to absorb the variability of the variable interest entity or the interest creates an amount of variability that offsets the amount of variability absorbed. The FASB staff and the Working Group had identified that issue as an issue that should be addressed when determining whether an interest is a variable interest. As a result, the FASB staff recharacterized the issues to be addressed as follows:

Issue 1(a)— The variability that should be considered when determining whether an interest is a variable interest

Issue 1(b)— The interests that absorb variability of the variable interest entity that should be considered variable interests of the variable interest entity.

10. The Task Force discussed the appropriate variability to be considered in Issue 1(a). Task Force members acknowledged that fair value variability and cash flow variability can both be important when determining whether an interest is a variable interest, but the Task Force raised conceptual and operational concerns about the use of a combined approach. The Task Force introduced a new approach to address Issue 1(a) that would require the identification of the predominant variability of the entity in determining whether either fair value variability or cash flow variability should be used to determine whether interests are variable interests in the entity.

When evaluating the predominant variability of the entity, the Task Force observed that an investor should consider, among other factors, the variability that the entity was designed to be exposed to. The Task Force directed the FASB staff to further develop this new approach and to include examples illustrating the application of this approach, as well as the fair value and cash flow approaches.

11. The Task Force did not specifically discuss Issue 1(b) at the September 29–30, 2004 EITF meeting.

Current EITF Discussion

12. At the November 17–18, 2004 EITF meeting, the Task Force discussed several alternatives for evaluating the predominant variability of an entity to determine whether the cash flow approach or the fair value approach should be used to determine whether interests are variable interests in the entity. The Task Force generally agreed that when considering whether an interest is a variable interest in a VIE, there should be a presumption that the fair value approach should be used for interests in financial VIEs and the cash flow approach should be used for interests in nonfinancial VIEs. The Task Force observed that this presumption could be overcome based on an analysis of certain characteristics of the VIE that would indicate that the alternative to the presumed approach is more appropriate for that VIE. The Task Force directed the FASB staff and the Working Group to develop (a) the criteria that would overcome the presumption, (b) a definition of a financial VIE, and (c) examples illustrating the application of the approach to financial and nonfinancial VIEs. The Task Force also asked the FASB staff to consider the impact of variability arising from interest rate risk and foreign currency risk on the presumed approach. Further, the Task Force indicated that, depending on the outcome of this approach for evaluating the predominant variability of an entity, it may consider whether it is appropriate to provide an exception to the analysis for interests that both create and absorb the same type and amount of variability.

13. The Task Force agreed to no longer consider the fair value, cash flow, or combined approaches as independent approaches. However, the Task Force will consider the approach discussed in paragraph 12, which will result in the application of the cash flow or fair value approach depending on the predominant variability of the potential VIE.

Status

14. Further discussion is expected at a future meeting.

Issue No. 04-11

Title: Accounting in a Business Combination for Deferred Postcontract Customer Support Revenue of a Software Vendor

Date Discussed: November 17–18, 2004

References: FASB Statement No. 141, *Business Combinations*

FASB Statement No. 143, *Accounting for Asset Retirement Obligations*

FASB Concepts Statement No. 6, *Elements of Financial Statements*

FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*

AICPA Statement of Position 97-2, *Software Revenue Recognition*

Introduction

1. Statement 141 requires that an acquiring enterprise allocate the cost of an entity acquired in a business combination to the individual assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. In some cases, the balance sheet of an acquired entity immediately before the acquisition date includes deferred revenue.

2. EITF Issue No. 01-3, "Accounting in a Business Combination for Deferred Revenue of an Acquiree," provides the following guidance:

> 3. …the acquiring entity should recognize a liability related to the deferred revenue of an acquired entity only if that deferred revenue represents a legal obligation[1] assumed by the acquiring entity (a legal performance obligation).
>
> 4. The Task Force noted that a legal obligation to provide goods, services, the right to use an asset(s), or some other consideration to a customer(s) would be examples of a legal performance obligation assumed by the acquiring entity. The Task Force also noted that an acquired entity might have deferred recognition of revenue because it is (or may be) obligated to grant the customer future concessions, as would be the case under a general right of return under Statement 48 or a price protection provision. The Task Force noted that the acquiring entity should recognize a liability if it has assumed a legal obligation to provide such concessions.
>
> 5. The Task Force noted that there are circumstances in which the deferred revenue of an acquired entity does not represent a legal performance obligation and, therefore, should not be recognized by the acquiring entity as a liability when the business combination is recorded. Examples of such circumstances are included in Exhibit 01-3A (Examples 1-4). [Not included herein.]

6. The Task Force observed that in accordance with Statement 141, when the acquirer recognizes a legal performance obligation related to a revenue arrangement of an acquired entity, the amount assigned to that liability should be based on its fair value at the date of acquisition.

[1]The Task Force observed that a legal obligation could arise from contractual provisions or from consumer rights in the relevant legal jurisdiction.

3. In the software industry, postcontract customer support (PCS) is an element that typically requires deferral of revenue in software licensing arrangements. The definition of PCS in the glossary to SOP 97-2, includes the following:

> The right to receive services (other than those separately accounted for as described in paragraphs .65 and .66 of this Statement of Position) or unspecified product upgrades/enhancements, or both, offered to users or resellers, after the software license period begins, or after another time as provided for by the PCS arrangement. Unspecified upgrades/enhancements are PCS only if they are offered on a when-and-if-available basis. PCS does not include the following:
>
> - Installation or other services directly related to the initial license of the software
> - Upgrade rights as defined in this Statement of Position
> - Rights to additional software products
>
> PCS may be included in the license fee or offered separately….
>
> The right to receive services and unspecified upgrades/enhancements provided under PCS is generally described by the PCS arrangement. Typical arrangements include services, such as telephone support and correction of errors (bug fixing or debugging), and unspecified product upgrades/enhancements developed by the vendor during the period in which the PCS is provided. PCS arrangements include patterns of providing services or unspecified upgrades/enhancements to users or resellers, although the arrangements may not be evidenced by a written contract signed by the vendor and the customer.

4. The final consensus in Issue 01-3 does not specifically address whether an acquiring entity should recognize a liability for "when-and-if-available upgrades" assumed in a business combination. As a result, diversity in practice exists as to whether a customer's right to receive unspecified upgrades/enhancements on a "when-and-if-available" basis under a PCS arrangement should be recognized as a legal performance obligation and measured at fair value.

5. Deferred PCS revenue often is significant for a software company as a result of the revenue recognition criteria in SOP 97-2. The fair value of deferred revenue in a business combination generally is not readily available and, accordingly, in practice, the fair value of a liability (which must arise from a legal performance obligation) for deferred revenue is estimated using various methods. Some software entities only include phone support and error fixes (and a fulfillment

margin thereon) in their measurement of the fair value of the liability for deferred PCS revenue. Other entities include the value of research and development activities for unspecified product upgrades/enhancements in their measurement of the fair value of the liability for deferred PCS revenue. Whether or not an entity includes the value of future research and development activities for unspecified upgrades in its measurement can have a significant effect on the amount of the liability for a PCS obligation that is recognized as deferred revenue in a business combination and, as a result, on the future earnings of the combined entity.

6. This Issue applies to software licensing arrangements for which the PCS element has been deferred because the related PCS services have not been performed, rather than to arrangements for which revenue has been deferred based on other facts and circumstances.

Issue

7. The issue is the unit of account that should be considered when recognizing the fair value of deferred PCS revenue in a business combination.

Current EITF Discussion

8. At the November 17–18, 2004 EITF meeting, the Task Force discussed this Issue, but was unable to reach a consensus. Accordingly, the Task Force agreed to discontinue discussion of this Issue and to remove it from the EITF's agenda.

Status

9. No further EITF discussion is planned.

Issue No. 04-12

Title: Determining Whether Equity-Based Compensation Awards Are Participating Securities

Date Discussed: November 17–18, 2004

References: FASB Statement No. 123, *Accounting for Stock-Based Compensation*
FASB Statement No. 128, *Earnings per Share*
Proposed FASB Statement, *Share-Based Payment*, issued March 31, 2004
APB Opinion No. 25, *Accounting for Stock Issued to Employees*

Introduction

1. Statement 128 provides guidance on the calculation and disclosure of earnings per share (EPS). Statement 128 defines EPS as "the amount of earnings attributable to each share of common stock," and indicates that the objective of EPS is to measure the performance of an entity over the reporting period. In its deliberations on Statement 128, the Board decided to require the use of the two-class method of computing EPS for those enterprises with participating securities or multiple classes of common stock.

2. Paragraph 60(a) of Statement 128 provides the following description of participating securities:

> Securities that may participate in dividends with common stocks according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share).

Paragraph 61 of Statement 128 adds the following:

> The if-converted method shall be used for those securities that are convertible into common stock if the effect is dilutive. For those securities that are not convertible into a class of common stock, the "two class" method of computing earnings per share shall be used. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Under that method:
>
> a. Income from continuing operations (or net income) shall be reduced by the amount of dividends declared in the current period for each class of stock and by the contractual amount of dividends (or interest on participating income bonds) that must be paid for the current period (for example, unpaid cumulative dividends).[25]
> b. The remaining earnings shall be allocated to common stock and participating securities to the extent that each security may share in earnings as if all of the earnings for the period had been distributed. The total earnings allocated to

each security shall be determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.

c. The total earnings allocated to each security shall be divided by the number of outstanding shares of the security to which the earnings are allocated to determine the earnings per share for the security.

d. Basic and diluted EPS data shall be presented for each class of common stock.

For the diluted EPS computation, outstanding common shares shall include all potential common shares assumed issued. Illustration 6 in Appendix C provides an example of that provision.

[25]Dividends declared in the current period do not include dividends declared in respect of prior-year unpaid cumulative dividends. Preferred dividends that are cumulative only if earned are deducted only to the extent that they are earned.

3. In EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128," the Task Force addressed a number of issues related to the application of paragraphs 60 and 61 of Statement 128. In Issue 03-6, the Task Force reached a consensus that a participating security is a security that may participate in undistributed earnings with common stock in its current form, whether that participation is conditioned upon the occurrence of a specified event or not. The Task Force also observed that the form of participation does not have to be a dividend for a security to qualify as participating—that is, any form of participation in undistributed earnings would constitute participation by that security, regardless of whether the payment to the security holder was referred to as a dividend. The Task Force also reached a consensus in Issue 03-6 that dividends or dividend equivalents transferred to the holder of a convertible security or other contract (security) to issue an entity's common stock in the form of a reduction to the conversion price or an increase in the conversion ratio are not participation rights.

4. At the September 29–30, 2004 EITF meeting, the Task Force confirmed that Issue 03-6 did not provide any guidance about whether unvested instruments that are issued as stock-based compensation are participating securities. The Task Force acknowledged that instruments issued as equity-based compensation possess certain characteristics that are different from the instruments addressed in Issue 03-6, such as vesting, and agreed to add to the EITF's agenda an Issue to address whether such instruments, including options and unvested restricted stock, that receive dividends declared on common stock are participating securities.

5. This Issue addresses whether unvested instruments issued as equity-based compensation that provide the right to receive a dividend or dividend equivalent with common stock are participating securities. This Issue includes dividends and dividend equivalents regardless of the accounting for the dividends—that is, whether the dividends are recognized either as compensation expense or as a charge to equity. This Issue does not address vested equity-based compensation, which is addressed in Issue 2(a) of Issue 03-6.

Issues

6. The issues are:

Issue 1—Whether unvested instruments issued as equity-based compensation (including options and nonvested stock) that provide the right to participate in dividends or dividend equivalents with common stock of the issuer are participating securities if the right to the dividends is contingent on factors other than employee service and the passage of time (for example, if such right is contingent on the exercise of a stock option or the achievement of specified performance targets (including those in the vesting requirements of an award))

Issue 2—Whether unvested instruments issued as equity-based compensation (including options and nonvested stock) that provide the right to participate in dividends or dividend equivalents with common stock of the issuer are participating securities if the right is nonforfeitable or contingent only on employee service and the passage of time.

Current EITF Discussion

7. At the November 17–18, 2004 EITF meeting, the Task Force discussed whether unvested instruments issued as equity-based compensation that provide the right to receive a dividend or dividend equivalent with common stock are participating securities. The Task Force generally agreed on Issue 1 that unvested instruments issued as equity-based compensation (including options and nonvested stock) are not participating securities if the right to dividends is contingent on factors other than employee service and the passage of time. However, the Task Force was not asked to reach a consensus on Issue 1.

8. The Task Force discussed Issue 2 but was unable to reach a consensus. Accordingly, the Task Force agreed to discontinue discussion of this Issue (both Issue 1 and Issue 2) and to remove it from the EITF's agenda. The FASB staff indicated that it will likely ask the Board to consider providing guidance on this Issue in the form of an FASB Staff Position.

Status

9. No further EITF discussion is planned.

Issue No. 04-13

Title: Accounting for Purchases and Sales of Inventory with the Same Counterparty

Date Discussed: November 17–18, 2004

References: FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*

AICPA Accounting Research Bulletin No. 43, Chapter 4, "Inventory Pricing"

APB Opinion No. 29, *Accounting for Nonmonetary Transactions*

Statement 133 Implementation Issue No. K1, "Miscellaneous: Determining Whether Separate Transactions Should Be Viewed as a Unit"

Statement 133 Implementation Issue No. K3, "Miscellaneous: Determination of Whether Combinations of Options with the Same Terms Must be Viewed as Separate Option Contracts or as a Single Forward Contract"

AICPA Technical Practice Aids, Section 5100.46, "Nonmonetary Exchanges of Software (Part 1)"

AICPA Technical Practice Aids, Section 5100.47, "Nonmonetary Exchanges of Software (Part II)"

Introduction

1. An entity may sell inventory to another entity in the same line of business from which it also purchases inventory. The purchase and sale transactions may be pursuant to a single contractual arrangement or separate contractual arrangements and the inventory purchased or sold may be in the form of raw materials, work-in-process, or finished goods. The following questions have been raised about the accounting for those types of transactions:

a. Under what circumstances should two or more transactions with the same counterparty (counterparties) be viewed as a single nonmonetary transaction within the scope of Opinion 29?

b. If nonmonetary transactions within the scope of Opinion 29 are exchanges of inventory within the same line of business, are there are circumstances under which the transactions should be recognized at fair value?

2. The FASB staff asked the Task Force to consider the second question, that is, are there any circumstances under which nonmonetary exchanges of inventory within the same line of business should be recognized at fair value. The Task Force may be asked to address the first question at a future meeting. Therefore, the scope of the Issue that the Task Force was asked to consider is limited to purchases and sales of inventory between entities in the same line of

business that are deemed nonmonetary transactions within the scope of Opinion 29.[1] The fundamental issue is whether the types of transactions in question are within the scope of paragraph 21(a) of Opinion 29, which requires that the transactions be recognized based on recorded amounts rather than fair value. Because paragraph 21(a) is limited to exchanges of inventory to be sold in the same line of business, only nonmonetary exchanges of inventory in the same line of business were considered by the Task Force.

Issue

3. The issue is whether there are circumstances under which nonmonetary exchanges of inventory within the same line of business should be recognized at fair value.

Current EITF Discussion

4. At the November 17–18, 2004 EITF meeting, the Task Force discussed whether there are circumstances under which nonmonetary exchanges of inventory within the same line of business should be recognized at fair value but did not reach a consensus. The Task Force focused on whether paragraph 21(a) of Opinion 29 was intended to apply to exchanges of all types of inventory (that is, raw materials, work-in-process, and finished goods) or only finished goods. The Task Force requested that the FASB staff further explore alternative views as to whether there are circumstances under which nonmonetary exchanges of inventory should be recognized at fair value including a view based on whether the transaction has "commercial substance." Additionally, Task Force members indicated that they would provide the FASB staff with examples of nonmonetary exchanges of inventory that are found in practice that include transactions that are accounted for both at fair value and at recorded amounts, and the basis for the measurement attribute selected.

Status

5. Further discussion is expected at a future meeting.

[1] If the amount of net monetary consideration in the exchange is at least 25 percent of the fair value of the exchange, the transaction(s) should be accounted for as a monetary transaction (or transactions) outside the scope of Opinion 29, in accordance with Issue 8(a) in EITF Issue No. 01-2, "Interpretations of APB Opinion No. 29."

Status of Open Issues and Agenda Committee Items

The following represents the FASB staff's assessment of the status and immediate plans with respect to the open Issues on the Task Force's agenda. The Issues on the proposed agenda for the March 16-17, 2005 meeting are considered either high priority issues or issues on which meaningful progress can be made within the staff's given complement of resources. The staff's prioritization of issues is based primarily on the FASB staff's understanding of the level of diversity in practice created by each respective Issue, the financial reporting implications of that diversity, the current interaction, if any, of the Issues with active Board projects, and current resource availability among the staff (with respect to both time and relevant technical expertise).

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
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	5/04	6/04, 9/04, 11/04	03/05	Larson Oakley	FASB staff will post a draft abstract to the FASB website for public comment. The Task Force will consider the comments received at the March 2005 meeting.	March meeting materials
04-6	Accounting for Stripping Costs in the Mining Industry	11/03	6/04, 9/04, 11/04	03/05	Westerlund Larson	The FASB staff will prepare an Issue Summary for the March 2005 meeting.	March meeting materials
04-7	Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity	5/04	6/04, 9/04, 11/04	03/05	Laurenzano Sogoloff Belcher	FASB staff to prepare an Issue Summary with assistance from the FIN 46(R) Resource Group for the March 2005 meeting.	March meeting materials

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
04-13	Accounting for Purchases and Sales of Inventory with the Same Counterparty	11/04	11/04	03/05	Oakley Belcher	The FASB staff will prepare an Issue Summary for the March 2005 meeting.	March meeting materials
04-J	The Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option That Otherwise Is Not Convertible or Not Currently Convertible Based on a Contingency	11/04	N/A	03/05	O'Callaghan Oakley	The FASB staff will prepare an Issue Summary for the March 2005 meeting.	March meeting materials

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	**Description**	**Date Added**	**Date(s) Discussed**	**Next Meeting**	**FASB Staff**	**Immediate Plans**	**Due Date - Next Deliverable**
00-18	Accounting Recognition for Certain Transactions involving Equity Instruments Granted to Other Than Employees	5/00	7/00, 7/01, 11/01, 1/02, 3/02	Not scheduled	Munro	Pending further progress in the Board's project on share-based payments (Phase II), which is expected to include recognition and measurement for share-based transactions with non-employees.	N/A
	The remaining issue in Issue 00-18 is Issue 3: For transactions that include a grantee performance commitment, how the grantee should account for the contingent right to receive, upon performing as specified in the arrangement, grantor equity instruments that are the consideration for the grantee's future performance. The Task Force asked the FASB staff to focus on improving the guidance (originally from Issue 96-18) used to determine the date at which a commitment for counterparty performance to earn the equity instruments is reached. The measurement date issues, as well as several of the other issues and subissues of Issue 00-18 (also related to Issues 96-18 and 00-8), will be under consideration in the Board's share-based payment project.						
00-27	Application of EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," to Certain Convertible Instruments	5/00	11/00, 1/01	Not scheduled	Laurenzano Richards	Pending further progress on Phase II of the Board's liabilities and equity project.	N/A

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	**Description**	**Date Added**	**Date(s) Discussed**	**Next Meeting**	**FASB Staff**	**Immediate Plans**	**Due Date - Next Deliverable**
02-D	The Effect of Dual-Indexation both to a Company's Own Stock and to Interest Rates and the Company's Credit Risk in Evaluating the Exception under Paragraph 11(a)(1) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*	3/02	N/A	Not scheduled	Laurenzano Sogoloff	Pending further progress on Phase II of the Board's liabilities and equity project.	N/A
03-15	Interpretation of Constraining Conditions of a Transferee in a Collateralized Bond Obligation Structure	9/00 (AC) 11/02 (TF)	N/A	Not scheduled	Laurenzano Lusniak	Pending developments in the Board's project on QSPE's and reconsideration by the FASB staff as to the extent of the issue.	N/A

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
03-17	Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity's Balance Sheet	5/03	11/03	Not scheduled	McBride O'Callaghan	Issue addresses the amortization of a recognized executory contract that has periods of both positive and negative cash flows. This issue is pending the Board's consideration of how the factors in paragraph 11(d) of Statement 142 should be evaluated in determining the useful life of an intangible asset (formerly EITF Issue 03-9)	N/A

Issues Pending Further Consideration by the Agenda Committee							
Issue No.	**Description**	**Date Added**	**Date(s) Discussed**	**Next Meeting**	**FASB Staff**	**Immediate Plans**	**Due Date - Next Deliverable**
N/A	Application of EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," When a Special-Purpose Entity Holds Equity Securities and Whether an Investment That Is Redeemable at the Option of the Investor Should Be Considered an Equity Security or Debt Security	9/00	N/A	Not scheduled	Laurenzano	Pending consideration of an FASB project that may address the measurement of beneficial interests in securitized financial instruments.	Pending develop-ments in a Board project