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**FINANCIAL ACCOUNTING STANDARDS BOARD**
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July 6, 2005

**TO: MEMBERS OF THE FASB EMERGING ISSUES TASK FORCE**

Included are the final minutes of the June 15–16, 2005 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 June 30 draft. After your review, please discard the confidential marked version of the minutes.

**September Meeting Time and Location**
The next EITF meeting will be held on **September 14–15, 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 September 14 and conclude no later than **4:00 p.m.** on September 15.

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

| | |
|---|---|
| **Draft minutes available** | **September 20, 2005** |
| **Final minutes available** | **October 4, 2005** |

**Agenda Committee Meeting**
The next Agenda Committee meeting has been scheduled for August 2, 2005. Please provide materials for any potential new issues before July 19, 2005.

Please call me at extension x212 if you have any questions about the minutes. Please direct any questions about the Agenda Committee meeting or the September EITF meeting to Jim Geary at (203) 909-5211 or jwgeary@fasb.org.

Sincerely,

Landon B. Westerlund
Practice Fellow

# MINUTES OF THE JUNE 15–16, 2005 MEETING OF THE FASB EMERGING ISSUES TASK FORCE

Location: FASB Offices
401 Merritt 7
Norwalk, Connecticut

Wednesday, June 15, 2005
Starting Time: 1:00 p.m.
Concluding Time: 4:55 p.m.

Thursday, June 16, 2005
Starting Time: 8:00 a.m.
Concluding Time: 3:50 p.m.

**Task Force Members Present:**
Lawrence W. Smith (Chairman)
Mark M. Bielstein
*Frank H. Brod
Jack T. Ciesielski
Mitchell A. Danaher
Leland E. Graul
Joseph F. Graziano
Stuart H. Harden
Jan R. Hauser
David L. Holman
James A. Johnson
Robert Uhl (AcSEC Observer)
Ashwinpaul C. (Tony) Sondhi
Richard H. Stock
Lawrence E. Weinstock
Scott A. Taub (SEC Observer)

**Task Force Members Absent:**
None

* For certain issues only.

**Others at Meeting Table:**
*Robert H. Herz, FASB Board Member
*George J. Batavick, FASB Board Member
G. Michael Crooch, FASB Board Member
*Katherine Schipper, FASB Board Member
Leslie F. Seidman, FASB Board Member
Edward W. Trott, FASB Board Member
Donald M. Young, FASB Board Member
Russell G. Golden, FASB Senior Technical Advisor
Landon B. Westerlund, FASB Practice Fellow
James W. Geary, FASB Practice Fellow
Shelly C. Luisi, SEC Senior Associate Chief Accountant
* Steven P. Belcher, FASB Practice Fellow
* Christopher J. Larson, FASB Practice Fellow
* Kevin T. McBride, FASB Industry Fellow
* Stuart J. Moss, FASB Practice Fellow
* Reginald D. Oakley, FASB Practice Fellow
* Gerard M. O'Callaghan, FASB Practice Fellow
* Brooke E. Richards, FASB Project Manager
* Eric M. Smith, FASB Industry Fellow
* Randall S. Sogoloff, FASB Practice Fellow
* Amie N. Thuener, FASB Practice Fellow

* For certain issues only.

## ADMINISTRATIVE MATTERS

- Prior Meeting Minutes. An FASB staff member solicited objections to the final minutes of the March 17, 2005 meeting. No objections were noted.

- The Task Force discussed the report on the EITF Agenda Committee meeting held on May 4, 2005. The following decisions were made by the Agenda Committee:

a. *Offsetting of a Right to Receive or an Obligation to Return Cash Collateral with a Net Derivative Position under a Master Netting Arrangement.* The Agenda Committee decided not to add this issue to the EITF's agenda. Based on a request from the Agenda Committee, the FASB staff agreed to pursue the issuance of an FASB Staff Position to provide guidance on this issue.

b. *Capitalization of Ground Lease and Building Lease Rental Costs Incurred during Construction.* The Agenda Committee agreed to add this Issue to the EITF's agenda. This Issue was discussed at the June 15–16, 2005 EITF meeting. Refer to the discussion of EITF Issue No. 05-3, "Accounting for Rental Costs Incurred during the Construction Period," elsewhere in these minutes.

c. *Whether the Lessor or the Lessee Should Recognize Leasehold Improvements.* The Agenda Committee decided not to add this issue to the EITF's agenda.

d. *Evaluation of Lease Term and Amortization Period for Leasehold Improvements for Leases Acquired in a Business Combination.* The Agenda Committee agreed to add this Issue to the EITF's agenda. The Agenda Committee also asked the staff to expand this Issue to address the amortization period for leasehold improvements that are acquired after lease inception. This Issue was discussed at the June 15–16, 2005 EITF meeting. Refer to the discussion of EITF Issue No. 05-6, "Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination," elsewhere in these minutes.

e. *Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Asset Retirement Obligations.* The Agenda Committee decided not to add this issue to the EITF's agenda. Based on a request from the Agenda Committee, the FASB staff agreed to pursue the issuance of an FASB Staff Position to provide guidance on this issue.

f. *Accounting for Modifications to Conversion Options Embedded in Debt Securities and Related Issues.* The Agenda Committee agreed to add this Issue to the EITF's agenda.

g. *Accounting for the Deferred Tax Consequences Associated with a Noncontrolling Investment Redeemed or Exchanged in a Nontaxable Business Combination.* The Agenda Committee decided not to add this issue to the EITF's agenda.

h. *Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature.* The Agenda Committee agreed to add this Issue to the EITF's agenda.

- The Task Force discussed the effects of FASB Statement No. 154, *Accounting Changes and Error Corrections*, on the application of EITF consensuses and made the following observations:

  1. The Task Force should continue to establish transition provisions for consensuses on an Issue-by-Issue basis by selecting the most appropriate transition for the specific circumstances. However, if no transition guidance is provided, an entity will be required to apply a consensus through retrospective application of that guidance to all prior periods, unless it is impractical to do so.
  2. The Task Force is not required to reconsider the transition provisions for any existing consensuses. However, for existing consensuses that may be adopted in periods beginning after December 15, 2005, the FASB staff recommended that the Task Force require that any cumulative-effect adjustments be recognized in beginning retained earnings (or other appropriate components of equity or net assets) for that period.
  3. The Task Force should consider the basis for conclusions in Statement 154 when deliberating the transition requirements of any future consensuses.

- The Task Force agreed to change the transition provisions of EITF Issue No. 04-6, "Accounting for Stripping Costs Incurred during Production in the Mining Industry," to require entities that adopt the consensus after Board ratification of this change (June 29, 2005) to recognize any cumulative-effect adjustment in retained earnings. This change is described in more detail in the Consensus Modification section of these minutes.

- The Task Force held a closed administrative session to discuss a recent review of the EITF process and procedures.

- The Task Force Chairman announced that Mr. Richard H. Stock will be retiring from ExxonMobil Corporation and, as a result, will be stepping down as a member of the EITF. The Task Force Chairman thanked Mr. Stock for his service. A replacement for Mr. Stock has not been named at this time.

- The Task Force Chairman welcomed Mr. Robert Uhl, Deloitte & Touche LLP, as the AcSEC Observer for this meeting.

- Comment letters on the following Issues were reported as received:[1]

a. 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" (1 comment letter)

b. EITF Issue No. 04-6, "Accounting for Stripping Costs Incurred during Production in the Mining Industry" (3 comment letters)

c. EITF Issue No. 05-3, "Accounting for Rental Costs Incurred during the Construction Period" (5 comment letters)

d. EITF Issue No. 05-6, "Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination" (1 comment letter).

- September 2005 EITF Meeting: The FASB staff asked Task Force members to anticipate a day-and-a-half EITF meeting to be held on September 14–15, 2005.

[1] Discussion of comment letters occurred during discussion of the related Issue.

## CONSENSUS MODIFICATION

**Issue No.** 01-9

**Title:** Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)

**Date Discussed:** June 15–16, 2005

The FASB staff received questions about the scope of Issue 4 in Issue 01-9 and whether the decision tree[1] appropriately reflects the consensus. The decision tree indicates that consideration that is delivered at the point of sale is within the scope of Issue 01-9 and that consideration that is delivered at other than the point of sale is not within the scope of Issue 01-9. However, the FASB staff believes that if the consideration is cash and it is payable to the customer as a result of a single exchange transaction, then Issue 01-9 applies, regardless of when the customer receives the cash (for example, a cash rebate that is mailed to the customer after the sales transaction). In contrast, if a sales incentive is offered in the form of products or services and the delivery is after the point of sale, Issue 01-9 does not apply. Accordingly, the FASB staff proposed certain modifications to the decision tree. Those proposed modifications are included in the attached appendix.

Additionally, the FASB staff proposed that the following footnote be added to Issue 4 to clarify the interaction between the consensus in Issue 4 and the scope of Issue 01-9 (additions are underscored).

> Issue 4—If a vendor offers a sales incentive voluntarily and without charge to customers that is exercisable by a customer as a result of a single exchange transaction, when should the vendor recognize and how should the vendor measure the cost of the sales incentive if it will not result in a loss on the sale of a product or service?[2]
>
> [2] As indicated in paragraph 7, this Issue does not address the accounting for an offer to a customer, in connection with a current revenue transaction, for free or discounted products or services from the vendor that is redeemable by the customer at a future date without a further exchange transaction with the vendor.

At the June 15–16, 2005 EITF meeting, the Task Force agreed to revise the decision tree and to add the footnote that was proposed by the FASB staff. The Status section of the abstract will be updated with the following:

> At the June 15–16, 2005 EITF meeting, the Task Force agreed to revise the decision tree in Exhibit 01-9F to clarify that if consideration is cash and it is payable to the customer as

[1] The decision tree is in Exhibit 01-9F in the abstract for Issue 01-9.

a result of a single exchange transaction, then Issue 01-9 applies, regardless of when the customer receives the cash. Additionally, the Task Force agreed to add a footnote to Issue 4 to clarify the interaction between the consensus in Issue 4 and the scope of Issue 01-9.

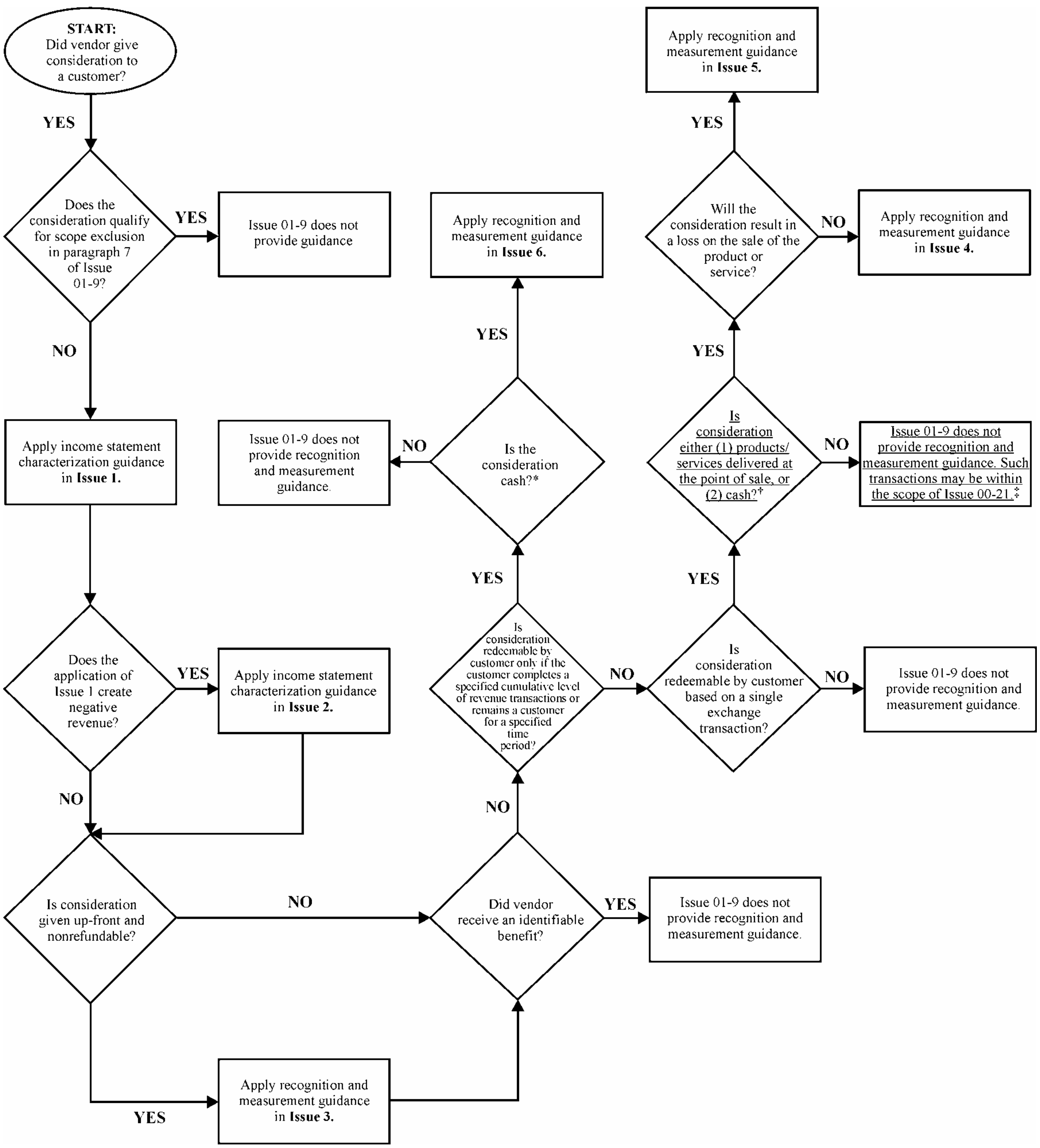
**Board Ratification**

At its June 29, 2005 meeting, the Board ratified the modifications to the consensus in this Issue.

## Appendix 01-9A

### MODIFICATIONS TO EXHIBIT 01-9F OF ISSUE 01-9
*(additions are underscored and deletions are included as footnotes)*

### DECISION TREE FOR USE IN THE APPLICATION OF THE GUIDANCE IN ISSUE 01-9

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* For purposes of this Issue, cash consideration includes "credits" that the customer can apply against trade amounts owed to the vendor. In addition, under the consensus on Issue 2 of Issue 96-18, consideration in the form of equity instruments is recognized "in the same period(s) and in the same manner (that is, capitalize versus expense) as if the

enterprise had paid cash for the goods or services or used cash rebates as a sales discount instead of paying with or using the equity instruments."  Accordingly, for purposes of this Issue, guidance with respect to cash consideration is applicable to consideration that consists of equity instruments (regardless of whether a measurement date has been reached).

† The Task Force agreed to revise this cell at its June 15–16, 2005 EITF meeting.  It previously stated the following: "Is consideration delivered at point of sale?"

†† The Task Force agreed to revise this cell at its June 15–16, 2005 EITF meeting.  It previously stated the following:  "Issue 01-9 does not provide recognition and measurement guidance."

**CONSENSUS MODIFICATION**

**Issue No.** 04-6

**Title:** Accounting for Stripping Costs Incurred during Production in the Mining Industry

**Date Discussed:** June 15–16, 2005

At the June 15–16, 2005 EITF meeting, the Task Force agreed to change the transition provisions of the consensus and to clarify the term *inventory produced*. The following addresses these modifications in more detail.

**Transition Provisions**

As a result of the issuance of FASB Statement No. 154, *Accounting Changes and Error Corrections*, the Task Force agreed to change the transition provisions of Issue 04-6 to require entities that adopt the consensus in periods beginning after Board ratification of this change (June 29, 2005) to recognize any cumulative-effect adjustment in retained earnings (or other appropriate component of equity or net assets). The following paragraph will replace paragraph 7 of the abstract:

> The consensus in this Issue is effective for the first reporting period in fiscal years beginning after December 15, 2005, with early adoption permitted. The effect of initially applying this consensus should be accounted for in a manner similar to a cumulative-effect adjustment as described in Opinion 20 with any adjustment recognized in the opening balance of retained earnings (or other appropriate component of equity or net assets) in the year of adoption.[1] Entities that elect to early adopt in an interim period should report the effects of this change in interim financial statements in a manner similar to that required by Statement 3 with any adjustment recognized in the opening balance of retained earnings (or other appropriate component of equity or net assets) in the year of adoption. An entity should disclose the amount of any adjustment to the opening balance of retained earnings (or other appropriate component of equity or net assets). Disclosure of the pro forma effects on net income is not required. Alternatively, an entity may recognize this change in accounting by restatement of its prior-period financial statements through retrospective application of this consensus.
>
> [1] If an entity adopts this consensus before June 29, 2005, it may apply the consensus in a manner similar to a cumulative-effect adjustment as described in paragraphs 19(a)–19(c) of Opinion 20 with any adjustment recognized in net income of the period of change. If the entity adopts the consensus in an interim period, it should report the effects in accordance with Statement 3. Disclosure of pro forma effects on net income is not required. Alternatively, an entity may recognize this change in accounting by restatement of its prior-period financial statements through retrospective application of this consensus.

**Clarification of the Term *Inventory Produced***

At the March 17, 2005 EITF meeting, the Task Force reached the following consensus on Issue 04-6, which was subsequently ratified by the Board at the March 30, 2005 Board meeting:

> The Task Force reached a consensus that stripping costs incurred during the production phase of a mine are variable production costs that should be included in the costs of the *inventory produced* during the period that the stripping costs are incurred. [Emphasis added.]

The FASB staff received a number of questions about the meaning of *inventory produced*. The FASB staff believes that the Task Force intended for "inventory produced" to mean "inventory extracted." That is, stripping costs incurred during a period should be attributed to the inventory that is extracted during that period.

At the June 15–16, 2005 EITF meeting, the Task Force agreed to clarify that "inventory produced" means "inventory extracted" in the consensus for this Issue. The first sentence of paragraph 6 of the abstract will be revised as follows (the revision is underscored):

> The Task Force reached a consensus that stripping costs incurred during the production phase of a mine are variable production costs that should be included in the costs of the inventory produced <u>(that is, extracted)</u> during the period that the stripping costs are incurred.

**Board Ratification**

At its June 29, 2005 meeting, the Board ratified the modifications to the consensus 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:** June 15–16, 2005

At the September 29–30, 2004 EITF meeting, the Task Force reached the following consensus on Issue 04-10, which was subsequently ratified by the Board at the October 13, 2004 Board meeting:

> Operating segments that do not meet the quantitative thresholds can be aggregated only if aggregation is consistent with the objective and basic principles of Statement 131, the segments have similar economic characteristics, and the segments share a majority of the aggregation criteria listed in (a)–(e) of paragraph 17 of FASB Statement No. 131.

The original effective date of this consensus was for fiscal years ending after October 13, 2004. However, at the November 17–18, 2004 EITF meeting, the Task Force agreed to delay the effective date of this consensus to coincide with the effective date of an anticipated FASB Staff Position (FSP) that would address the meaning of similar economic characteristics (proposed FSP FAS 131-a, "Determining Whether Operating Segments Have Similar Economic Characteristics under Paragraph 17 of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*").

At its May 18, 2005 meeting, the Board decided not to issue proposed FSP FAS 131-a. Because the Board plans no further activity on this issue, the FASB staff asked the Task Force to reconsider the effective date of Issue 04-10.

At the June 15–16, 2005 EITF meeting, the Task Force reconsidered the effective date of the consensus in this Issue and agreed that the consensus should be effective for fiscal years ending after September 15, 2005. Additionally, the corresponding information for earlier periods, including interim periods, should be restated unless it is impractical to do so.

Paragraph 7 of the abstract will be replaced with the following:

> The consensus in this Issue should be applied for fiscal years ending after September 15, 2005. The corresponding information for earlier periods, including interim periods, should be restated unless it is impractical to do so. Early application of the consensus is permitted.

The following paragraph will be added to the Status section of the abstract:

At the June 15–16, 2005 EITF meeting, the Task Force discussed the effective date of the consensus in this Issue. The Task Force previously agreed that the effective date of this consensus should coincide with the effective date of an anticipated FSP that would address the meaning of similar economic characteristics (proposed FSP FAS 131-a, "Determining Whether Operating Segments Have Similar Economic Characteristics under Paragraph 17 of FASB Statement No. 131"). At its May 18, 2005 meeting, the Board decided not to issue proposed FSP FAS 131-a. Because the Board plans no further activity on this issue, the Task Force reconsidered the effective date for the consensus. The Task Force agreed that the consensus in this Issue should be applied for fiscal years ending after September 15, 2005, and that the corresponding information for earlier periods, including interim periods, should be restated unless it is impractical to do so. Early application of the consensus is permitted.

**Board Ratification**

At its June 29, 2005 meeting, the Board ratified the change to the effective date for the guidance in this Issue.

## DISCUSSION OF AGENDA TECHNICAL ISSUES

**Issue No.** 04-5

**Title:** Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights[1]

**Dates Discussed:** June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004; March 17, 2005; June 15–16, 2005

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

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 Statement No. 154, *Accounting Changes and Error Corrections*

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)[2] 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 the limited

[1] Formerly entitled, "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."
[2] Refer to paragraph B20 of Interpretation 46(R).

partners 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 originally considered by the Task Force was when a sole general partner should consolidate a limited partnership.

**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 controls and 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 presumed 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.

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 would be consistent with Issue 96-16.

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.

9. The Task Force asked the FASB staff to post a draft abstract to the FASB website for public comment. 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.

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. 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 consistent with the tentative conclusions reached at the November EITF meeting. 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.

12. At its March 17, 2005 EITF meeting, the Task Force considered the comment letters on the draft abstract reflecting the tentative conclusions from the November EITF meeting. The draft abstract and the proposed amendment to SOP 78-9 (proposed FSP SOP 78-9-a, "Interaction of AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures,* and EITF Issue No. 04-5, 'Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights'") were posted to the FASB website for comment on December 22, 2004, for a 60-day comment period. Based on its consideration of the comment letters and further discussion, the Task Force reached the following tentative conclusions on a revised framework for addressing when the general partners in a limited partnership control the limited partnership (these tentative conclusions are incorporated into the revised draft abstract in Appendix 04-5A):

a. The scope of this Issue should be expanded to include all limited partnerships and similar entities, including those that have multiple general partners, and should be limited to the question of whether the general partner, or general partners as a group, controls the limited partnership. The title of this Issue has been changed to reflect the revised scope. The Task Force acknowledged that a limited partnership may be controlled by a group of general partners jointly. The Task Force further acknowledged that when a limited partnership is controlled by a group of general partners, the determination of which, if any, general partner within the group should consolidate is based on an analysis of the relevant facts and circumstances. If a single general partner in a group of general partners does not control the general partnership interests in the limited partnership, the guidance in this Issue need not be applied. The Task Force agreed that guidance on determining which general partner in a group of general partners should consolidate the limited partnership is beyond the scope of this Issue.
b. The general partner, or the general partners as a group, is presumed to control the limited partnership regardless of the general partners' ownership interest in the limited partnership. The Task Force acknowledged the comment letters that questioned whether including a limited partnership in the consolidated financial statements of a general partner that owns an insignificant interest results in a meaningful financial statement presentation. However, the Task Force observed that financial statement presentation and disclosure alternatives exist that may address that concern, including the option of providing consolidating financial statements or separate classification of the assets and liabilities of the limited partnership(s) on the face of the balance sheet.
c. Kick-out rights are considered to be substantive if those rights can be exercised by a simple majority (or a lower percentage) of the limited partners voting interests held by parties other than the general partners, entities under common control with the general partners, and other parties acting on behalf of the general partners. The Task Force also concluded that all relevant facts and circumstances should be considered in assessing whether other parties, including, but not limited to, those defined as related parties in Statement 57, may also be acting on behalf of the general partners in exercising their voting rights as limited partners. The Task Force concluded that, for purposes of this Issue, a simple majority is the minimum number of votes necessary to achieve a proportion of the relevant voting interests greater than 50 percent. The Task Force also agreed that the application of the simple majority threshold should be illustrated.

d. Rights that provide the limited partners with the ability to block acquisitions and dispositions of assets that would be expected to be made in the ordinary course of business are participating rights. In determining whether the right is substantive, judgment must be exercised in assessing whether acquisition and disposition decisions would occur in the ordinary course of business. An analysis of the "Factors to Consider," included in the draft abstract, should be undertaken in applying such judgment to the relevant facts and circumstances. Rights to block or approve acquisitions and dispositions that are not expected to be made in the ordinary course of business are protective rights.

13. The Task Force also directed the FASB staff to consider changes to Issue 96-16 that would conform the guidance in that Issue about whether minority shareholder rights to veto acquisitions and dispositions of assets greater than 20 percent of the fair value of the investee's total assets may be substantive participating rights to the guidance in this Issue. The Task Force directed the FASB staff to seek input from constituents on the impact of the proposed change to Issue 96-16 on current and prior practice. Accordingly, the FASB staff drafted a proposed change to Issue 96-16 and posted it to the FASB website on April 7, 2005, for a 30-day public comment period.

14. The Task Force Chairman indicated that the FASB would postpone any further consideration of proposed FSP SOP 78-9-a until the Task Force reaches a final consensus on this Issue.

**Current EITF Discussion**

15. At the June 15–16, 2005 EITF meeting, the Task Force reached a consensus on a framework for addressing when a general partner, or the general partners as a group, in a limited partnership controls the limited partnership. During its deliberations, the Task Force considered a number of issues that were raised subsequent to the March 17, 2005 EITF meeting. The Task Force reached the following conclusions on those issues and incorporated them, where appropriate, into the consensus guidance included in the draft abstract in Appendix 04-5A:

a. The Task Force agreed that kick-out rights that can be exercised by a single limited partner would be substantive (assuming no barriers to exercise the kick-out rights exist) even if the partnership agreement requires that more than a simple majority of the limited partners voting interests are required to exercise the kick-out right. In assessing whether a single limited partner has the ability to remove the general partners, consideration should be given to whether other parties, including, but not limited to, those defined as related parties in Statement 57, may be acting with the limited partner in exercising their kick-out rights. The Task Force also observed that a kick-out right that contractually requires a vote in excess of a simple majority (such as a supermajority) of the limited partners voting interests to remove the general partners may still be substantive if the general partners could be removed in every possible voting scenario in which a simple majority of the limited partners voting interests vote for removal. That is, there is no combination of the limited partners voting interests that represents at least a simple majority of the limited partners voting interests that cannot remove the general partners.

To illustrate this concept, consider the following examples based on a limited partnership agreement that requires a vote of 66.6 percent of the limited partners voting interests to remove the general partner:

Scenario 1: There are 3 independent limited partners that each hold an equal percentage (33.33 percent) of the limited partners voting interests. A vote of 2 of the 3 limited partners represents 66.7 percent of the limited partners voting interests, which also represents the smallest possible combination of voting interests that is at least a simple majority of the limited partners voting interests. Assuming there are no barriers to the exercise of the kick-out rights, the kick-out rights in this scenario meet the simple majority requirement and therefore represent substantive kick-out rights that overcome the presumption of control by the general partners.

Scenario 2: There are 3 independent limited partners that hold 45 percent (LP1), 25 percent (LP2), and 30 percent (LP3) of the limited partners voting interests. To remove the general partners, a vote of LP1 in combination with either LP2 or LP3 would be a simple majority of the limited partners and would satisfy the 66.6 percent contractual requirement. In contrast, a vote to exercise the kick-out right by LP2 and LP3 would also represent a simple majority of the limited partners; however, their voting interest (55 percent) would not meet the required threshold of 66.6 percent to remove the general partners. Accordingly, the kick-out right under this scenario would be assessed as nonsubstantive because the smallest possible combination (LP2 and LP3) that represents at least a simple majority of the limited partners voting interests cannot remove the general partners. Assuming the limited partners do not possess substantive participating rights, the presumption of control by the general partners is not overcome.

b. The Task Force discussed a suggestion to revise Example 1 of Exhibit 04-5A in the draft abstract to indicate that using a specific threshold (for example, 20 percent) in applying paragraph 14(d) of the draft abstract may be appropriate in certain circumstances. However, the Task Force affirmed the conclusion that the evaluation of "ordinary course of business" is based on facts and circumstances and, therefore, declined to revise the example.

c. At the March 17, 2005 EITF meeting, the Task Force tentatively concluded that no specific disclosures should be required in a consensus on this Issue. In response to questions raised after the March meeting, the Task Force revisited the question of disclosures and re-affirmed the tentative conclusion reached at the March meeting. As a result, the consensus in this Issue does not require disclosures incremental to those already required by existing generally accepted accounting principles.

d. The Task Force discussed a suggestion to "grandfather," upon initial application of the consensus, kick-out rights that require a vote in excess of a simple majority if the kick-out rights otherwise meet the remaining required characteristics of substantive kick-out rights in paragraph 7 of the draft abstract. The Task Force declined to incorporate this suggestion into the transition provisions of the consensus.

16. The Task Force revisited the transition provisions for this Issue in light of Statement 154. The Task Force concluded that a cumulative-effect-type adjustment that is recognized upon the adoption of this Issue under Transition Method A should be recognized as a component of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the period that this Issue is applied. The Task Force further concluded that the description of the transition provisions should conform to Statement 154 where appropriate.

17. The Task Force discussed the comments received on the proposed amendment to Issue 96-16 and approved amending the consensus as previously proposed by the Task Force (see below). The Task Force also reached a consensus that the amendment to Issue 96-16 should be applied prospectively to new investments and to investment agreements that are modified after ratification of the amendment by the Board. Accordingly, the following changes to Issue 96-16 will be reflected in *EITF Abstracts* in the Protective Rights and Status sections, as well as in Example 1 of Exhibit 96-16A (additions are underscored and deletions are scored through):

**Protective Rights**

The Task Force believes that minority rights (whether granted by contract or by law) that would allow the minority shareholder to block the following corporate actions would be considered protective rights and would not overcome the presumption of consolidation by the investor with a majority voting interest in its investee [Note: See STATUS section.]:

1. Amendments to articles of incorporation of the investee
2. Pricing on transactions between the owner of a majority voting interest and the investee and related self-dealing transactions
3. Liquidation of the investee or a decision to cause the investee to enter bankruptcy or other receivership
4. Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business ~~greater than 20 percent of the fair value of the investee's total assets~~ (minority rights relating to acquisitions and dispositions of assets that are expected to be made in the ordinary course of business are ~~20 percent or less do not necessarily lead to the conclusion that it is a substantive~~ participating rights; determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances—see "Factors to Consider" and Exhibit 96-16A)
5. Issuance or repurchase of equity interests.

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

**STATUS**

At the June 15–16, 2005 EITF meeting, the Task Force agreed to amend the Protective Rights section of this consensus, as well as Example 1 of Exhibit 96-16A, to be consistent with the consensus reached in Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the

Limited Partners Have Certain Rights." The changes resulting from this amendment have been marked herein, additions have been underscored and deletions have been struck through. The Task Force reached a consensus that the provisions of this amendment should be applied prospectively to new investments and to investment agreements that are modified after the date of ratification of the amendment by the Board. At its meeting on June 29, 2005, the Board ratified this amendment.

**Exhibit 96-16A**

**EXAMPLES OF HOW TO ASSESS INDIVIDUAL MINORITY RIGHTS UNDER THE CONSENSUS IN ISSUE 96-16**

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

1. The rights of the minority shareholder relating to the approval of acquisitions and dispositions of assets that are <u>expected to be undertaken in the ordinary course of business</u> ~~20 percent or less of the fair value of the investee's total assets and that are closely related to the investee's existing business (that is, same line of business)~~ may be substantive participating rights. Rights related only to acquisitions that are not <u>expected to be undertaken in the ordinary course of</u> ~~closely related to~~ the investee's existing business usually are protective and would not overcome the presumption of consolidation by the investor with a majority voting interest in its investee. <u>Whether a right to approve the acquisition or disposition of assets is "in the ordinary course of business" should be based on an evaluation of the relevant facts and circumstances.</u> In addition, if approval by the shareholder is necessary to incur additional indebtedness to finance an acquisition that is not in the investee's ordinary course of business ~~(that is, an acquisition greater than 20 percent of the fair value of the investee's total assets or an acquisition of an investee that is not in the same line of business)~~, then the approval by the minority would be considered a protective right.

### Board Ratification

18. At its June 29, 2005 meeting, the Board ratified the consensus reached by the Task Force in this Issue and the amendment to Issue 96-16.

### Status

19. No further EITF discussion is planned.

**Appendix 04-5A**

***EITF Abstracts* (DRAFT[1])**

**Issue No. 04-5**

**Title:** Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights

**Dates Discussed:** June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004; March 17, 2005; June 15–16, 2005

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

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 Statement No. 154, *Accounting Changes and Error Corrections*

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*

## ISSUE

1. For many years, financial statement preparers and auditors have debated how to evaluate whether a partnership is controlled by one of its partners. Recent guidance provided in Interpretation 46(R)[2] regarding "kick-out" rights in the context of evaluating variable interests

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

and consolidation of variable interest entities has renewed the debate over what considerations are relevant in determining whether the general partners control a limited partnership. In practice today, the question of whether a partnership is controlled 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 the limited partners rights are *important rights* that, under SOP 78-9, might preclude a general partner from controlling 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 general partner, or the general partners as a group, controls a limited partnership or similar entity when the limited partners have certain rights.

**Scope**

3. The scope of this Issue is limited to limited partnerships[3] or similar entities (such as limited liability companies that have governing provisions that are the functional equivalent of a limited partnership) that are not variable interest entities under Interpretation 46(R). This Issue does not apply to a general partner that, in accordance with generally accepted accounting principles, carries its investment in the limited partnership at fair value with changes in fair value reported in a statement of operations or financial performance. That is, if an enterprise is required to apply the consolidation guidance included in ARB 51 and Statement 94 to its investment in a limited partnership, it is within the scope of this Issue.[4] 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.

[3] When used throughout this Issue, the term *limited partnerships* shall mean either a limited partnership or a similar entity.

[4] This guidance applies to not-for-profit entities that are required to apply the consolidation guidance in ARB 51 and Statement 94 for their investments in partnership entities.

4. The Task Force acknowledged that when a limited partnership has multiple general partners, the determination of which, if any, general partner within the group controls and, therefore, should consolidate the limited partnership is based on an analysis of the relevant facts and circumstances.[5] If no single general partner in a group of general partners controls the limited partnership, the guidance in this Issue need not be applied. The Task Force agreed that guidance on determining which general partner in a group of general partners should consolidate is beyond the scope of this Issue. However, a Task Force member observed that the concepts in this Issue may be helpful in determining whether a single general partner in a group of general partners controls a limited partnership, particularly in relation to assessing whether the combined rights of the other general partners and the limited partners taken together overcome a conclusion that a single general partner controls a limited partnership.

**EITF DISCUSSION**

5. The Task Force reached a consensus that the *general partners*[6] in a limited partnership should determine whether they control a limited partnership based on the application of the framework in paragraphs 6–21.

**Presumption of Control**

6. The general partners in a limited partnership are presumed to control that limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership.[7] The assessment of whether the rights of the limited partners[8] should overcome the presumption of control by the general partners is a matter of judgment that depends on facts and circumstances. If the limited partners have either (a) the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause or (b)

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[5] In situations involving multiple general partners, entities under common control are considered to be a single general partner for purposes of applying the guidance in this Issue.

[6] The term *general partners* refers to one or more general partners and has this meaning when used in the context of this Issue.

[7] The Task Force observed that an entity has financial statement and disclosure alternatives that may provide additional useful information. For example, an entity may highlight the effects of consolidating a limited partnership by providing consolidating financial statements or separately classifying the assets and liabilities of the limited partnership(s) on the face of the balance sheet.

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

substantive participating rights, the general partners do not control the limited partnership. Further guidance on each of these concepts is provided below.

**Do the limited partners have the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause?[9]**

7. For purposes of this Issue, the rights underlying the limited partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners are collectively referred to as kick-out rights. The 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 single limited partner or a vote of a simple majority[10] (or a lower percentage) of the limited partners voting interests held by parties other than the general partners, entities under common control with the general partners or a general partner, and other parties acting on behalf of the general partners or a general

[9] *Without cause* means that no reason need be given for the dissolution (liquidation) of the limited partnership or removal of the general partners. *With cause* generally restricts the limited partners' ability to dissolve (liquidate) the limited partnership or remove the general partners in situations that include, but that would not be limited to, fraud, illegal acts, gross negligence, and bankruptcy of the general partners.

[10] To illustrate the application of the "simple majority" threshold, consider the following examples in which the limited partnership agreement requires a simple majority of the limited partners voting interests to remove the general partner: (1) Assume that a limited partnership has 3 limited partners, none of which have any relationship to the general partners, and that each holds an equal amount of the limited partners voting interests (33.33 percent). In this case, applying the simple majority requirement in the partnership agreement would require a vote of no more than two of the three limited partners to remove the general partners. Accordingly, a provision that entitles any individual limited partner to remove the general partner or a provision that requires a vote of two of the limited partners to remove the general partner would meet the requirements of paragraph 7(a) for a substantive kick-out right. However, if a vote of all three limited partners is required to remove the general partner, the right would not meet the requirements of paragraph 7(a) for a substantive kick-out right because the required vote is greater than a simple majority of the limited partners voting interests. (2) Consider the same facts as in Example 1, except that there are two limited partners that each hold an equal interest. In this case, a "simple majority" of the limited partners voting interests would require a vote of both limited partners, so a provision entitling any individual limited partner to remove the general partner or a provision that requires a vote of both limited partners to remove the general partner would meet the requirements of paragraph 7(a) for a substantive kick-out right. (3) Consider the same facts as in Example 1, except that there are 100 limited partners that each hold an equal interest. In this case, a "simple majority" of the limited partners voting interests would require a vote of 51 limited partners, so a provision that requires a vote of less than 52 limited partners to remove the general partner would meet the requirements of paragraph 7(a) for a substantive kick-out right. However, if a vote of 52 or more limited partners is required to remove the general partner, that provision would not meet the requirements of paragraph 7(a) for a substantive kick-out right because the required vote is greater than a simple majority of the limited partners voting interests.

partner. The Task Force observed that a kick-out right that contractually requires a vote in excess of a simple majority (such as a supermajority) of the limited partners voting interests to remove the general partners may still be substantive if the general partners could be removed in every possible voting scenario in which a simple majority of the limited partners voting interests vote for removal. That is, there is no combination of the limited partners voting interests that represents at least a simple majority of the limited partners voting interests that cannot remove the general partners.[11] The Task Force believes that all relevant facts and circumstances should be considered in assessing whether other parties, including, but not limited to, those defined as related parties in Statement 57, may be acting on behalf of the general partners in exercising their voting rights as limited partners. Similarly, in assessing whether a single limited partner has the ability to remove the general partners, consideration should be given to whether other parties, including, but not limited to, those defined as related parties in Statement 57, may be acting with the limited partner in exercising their kick-out rights.

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

[11] To illustrate this concept, consider the following examples based on a limited partnership agreement that requires a vote of 66.6 percent of the limited partners voting interests to remove the general partner:

*Scenario 1:* There are 3 independent limited partners that each hold an equal percentage (33.33 percent) of the limited partner voting interest. A vote of 2 of the 3 limited partners represents 66.7 percent of the limited partners voting interests, which also represents the smallest possible combination of voting interests that is at least a simple majority of the limited partners voting interests. Assuming there are no barriers to the exercise of the kick-out rights, the kick-out rights in this scenario meet the simple majority requirement and therefore represent substantive kick-out rights that overcome the presumption of control by the general partners.

*Scenario 2:* There are 3 independent limited partners that hold 45 percent (LP1), 25 percent (LP2), and 30 percent (LP3) of the limited partners voting interests, respectively. To remove the general partners, a vote of LP1 in combination with either LP2 or LP3 would be a simple majority of the limited partners and would satisfy the 66.6 percent contractual requirement. In contrast, a vote to exercise the kick-out right by LP2 and LP3 also would represent a simple majority of the limited partners; however, their voting interests (55 percent) would not meet the required threshold of 66.6 percent to remove the general partners. Accordingly, the kick-out right under this scenario would be assessed as nonsubstantive because the smallest possible combination (LP2 and LP3) that represents at least a simple majority of the limited partners voting interests cannot remove the general partners. Assuming the limited partners do not possess substantive participating rights, the presumption of control by the general partners is not overcome.

(2) Financial penalties or operational barriers associated with dissolving (liquidating) the limited partnership or replacing the general partners 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 the lack of adequate 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.

8. For purposes of applying paragraph 7, the limited partners' unilateral right to withdraw from the partnership in whole or in part (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership would not overcome the presumption that the general partners control the limited partnership (that is, the withdrawal right is not deemed to be a kick-out right). The requirement to dissolve or liquidate the entire limited partnership upon the withdrawal of a limited partner or partners is not required to be contractual for a withdrawal right to be considered as a potential kick-out right.

9. If, based on the preceding evaluation, the limited partners possess substantive kick-out rights, presumption of control by the general partners would be overcome and each of the general partners would account for its investment in the limited partnership using the equity method of accounting.

**Do the limited partners have substantive participating rights?**

10. If the limited partners have substantive participating rights, the presumption of control by the general partners would be overcome and each of the general partners would 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 general partners control the limited partnership. The Task Force agreed that limited partners' rights, individually or in the aggregate, 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 general partners control 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 the general partners.

13. 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 general partners.

**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 by the general partners.

a. Amendments to the limited partnership agreement.
b. Pricing on transactions between the general partners and the limited partnership and related self-dealing transactions.
c. Liquidation of the limited partnership initiated by the general partners or a decision to cause the limited partnership to enter bankruptcy or other receivership.
d. Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business. (Limited partners' rights relating to acquisitions and dispositions that are expected to be made in the ordinary course of the limited partnership's business are participating rights. Determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances—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 general partners control the limited partnership:

a. Selecting, terminating,[12] *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.

[12] Rights held by the limited partners to remove the general partners from the partnership should be evaluated as kick-out rights pursuant to paragraph 7 of this Issue. Rights of the limited partners to participate in the termination of management (for example, management is outsourced to a party other than the general partner) or the individual members of management of the limited partnership may be substantive participating rights.

17. The Task Force believes that in evaluating the limited partners' rights to determine whether they are substantive, *participation* means the ability of the limited partners to approve or block actions proposed by the general partners. That is, the general partners 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 general partners), 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 by the general partners 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. The limited partnership agreement needs to be considered to determine at what level decisions are made—by the general partners 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 partnership as a whole, are substantive should be based on a consideration of all relevant facts and circumstances.

b. Relationships between the general partners 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 general partners of the limited partnership, then the rights of the limited partner likely would not overcome the presumption of control by the general partners.

c. 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 by the general partners. 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.

d. 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 general partners have control if it is remote[13] that the event or transaction that requires the limited partners' approval will occur.

e. General partners who have 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 general partners, the general partners' 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 general partners rather than create an additional ownership interest for the general partners. It would not be "prudent, feasible, and substantially within the control of the general partners" 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 general partners should be made when an investor(s) first becomes a general partner(s) and should be reassessed at each reporting period thereafter for which financial statements of the general partner(s) are prepared.

**Transition**

22. The Task Force reached a consensus that for general partners of all new limited partnerships formed and for existing limited partnerships for which the partnership agreements are modified,

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

the guidance in this Issue is effective after June 29, 2005. The Task Force also reached a consensus that for general partners in all other limited partnerships, the guidance in this Issue is effective no later than the beginning of the first reporting period in 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 the first reporting period in 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 beginning of the first quarter of 2006, based on agreements in effect at the time of adoption. For a company with a fiscal year ending on December 31 that does not issue interim financial statements, the guidance must be applied in the annual statements as of the beginning of the year ended December 31, 2006.

24. The effect of initially applying this guidance for existing limited partnership agreements should be accounted for in a manner similar to a cumulative-effect-type adjustment. 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 (or other appropriate components of equity or net assets) at the beginning of the period in which this guidance is first applied should be included in the opening balance of retained earnings (or other appropriate components of equity or net assets) in the period of the change. For entities that elect to early-adopt this consensus in an interim period, any cumulative-effect-type adjustment should be recognized in retained earnings (or other appropriate components of equity or net assets) as of the beginning of the year of adoption. That is, the entity should continue to apply the provisions of Statement 3 with the exception that the cumulative-effect-type adjustment should be recognized in beginning retained earnings (or other appropriate component of equity or net assets) for that fiscal year. 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 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*.[14]

***Transition Method B***

26. Alternatively, for existing limited partnership agreements that have not been modified, this guidance may be applied by retrospective application. If an entity applies this consensus through retrospective application, it should apply the guidance in paragraphs 7–8 and 10 of Statement 154 and provide the disclosures required by paragraph 17 of Statement 154. If an entity applies this guidance retrospectively, it should apply it to all existing limited partnership agreements based on the facts and circumstances at the time each investment was made and it should 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, retrospective application is not required for investments in limited partnerships for which the entity is no longer a general partner as of the date that the guidance in this consensus is adopted.

**Board Ratification**

27. At its June 29, 2005 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

[14] For example, an exchange of securities accounted for based on recorded amounts, under the presumption that control had not been obtained (pursuant to paragraph 21 of Opinion 29 and 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.

## STATUS

28. No further EITF discussion is planned.

**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 expected to be undertaken in the ordinary course of business may be substantive participating rights. Rights related only to acquisitions that are not expected to be undertaken in the ordinary course of business usually are protective and would not overcome the presumption of control by the general partners in the limited partnership. Whether the right to approve the acquisition or disposition of assets is "in the ordinary course of business" should be based on an evaluation of the relevant facts and circumstances. 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, 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 partnership's 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 the general partners need to be considered to determine whether the rights of the limited partners to block have substance. For example, if (a) the limited partnership agreement provides that if the limited partners block the approval of operating and capital budgets, then the budgets simply default to last year's budgets adjusted for inflation and (b) the limited partnership operates in a mature business for which year-to-year operating and capital budgets would not be expected to vary significantly, then the rights of the limited partners to block the approval of the operating and capital budgets do 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 substantive participating rights.

**Example 8**

The limited partners have the right to veto the annual operating and capital budgets 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' right (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 general partners control the partnership would not be overcome.

**Issue No.** 04-13

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

**Dates Discussed:** November 17–18, 2004; March 17, 2005; June 15–16, 2005

**References:** FASB Statement No. 49, *Accounting for Product Financing Arrangements*

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

FASB Statement No. 153, *Exchanges of Nonmonetary Assets*

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)"

## Issue

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 (WIP), or finished goods. Questions have been raised about the accounting for those types of transactions.

2. The issues are:

Issue 1— The circumstances under which two or more inventory transactions with the same counterparty should be viewed as a single nonmonetary transaction within the scope of Opinion 29

Issue 2— Whether there are circumstances under which nonmonetary exchanges of inventory within the same line of business should be recognized at fair value.

## Prior EITF Discussion

3. 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, WIP, and finished goods) or only finished goods inventory. 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" as defined by Statement 153.

4. At the March 17, 2005 EITF meeting, the Task Force reached a tentative conclusion on Issue 2 that a nonmonetary exchange whereby finished goods inventory is transferred in exchange for the receipt of raw materials or WIP inventory within the same line of business is not an *exchange transaction to facilitate sales to customers* as described in paragraph 20(b) of Opinion 29, as amended by Statement 153,[1] and, therefore, should be recognized by the entity at fair value if (a) fair value is determinable within reasonable limits and (b) the transaction has commercial substance (paragraphs 20 and 21 of Opinion 29). All other nonmonetary exchanges of inventory within the same line of business should be recognized at the carrying amount of the inventory transferred. That is, a nonmonetary exchange within the same line of business involving (a) the transfer of raw materials or WIP inventory in exchange for the receipt of raw materials, WIP, or finished goods inventory or (b) the transfer of finished goods inventory for the receipt of finished goods inventory would not be recognized at fair value. The Task Force also reached a tentative conclusion that the classification of a type of inventory for purposes of this Issue should be the same classification that an entity uses for external financial reporting purposes. The Task Force also agreed that an entity should disclose the amount of revenue and costs (or gains and losses) associated with inventory exchanges recognized at fair value. Further, the FASB staff observes that this Issue does not address whether these transactions qualify for revenue recognition.

5. The Task Force requested that the FASB staff further explore with the assistance of a working group circumstances in which two or more inventory transactions with the same counterparty should be viewed as a single nonmonetary transaction within the scope of Opinion 29 (Issue 1).

**Current EITF Discussion**

6. At the June 15–16, 2005 EITF meeting, the Task Force agreed that the scope of this Issue should apply only to inventory buy/sell arrangements that are not accounted for as derivatives under Statement 133. In addition, the Task Force agreed that the scope of this Issue excludes inventory transactions that involve exchanges of software or exchanges of real estate.

7. The Task Force reached a tentative conclusion on Issue 1 that inventory purchase and sales transactions with the same counterparty that are entered into in contemplation of one another should be combined for purposes of applying Opinion 29. The Task Force agreed that in situations in which an inventory transaction is legally contingent upon the performance of

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[1] Any final consensus on this Issue will be reached after the effective date of Statement 153. Statement 153 amends Opinion 29 to require nonmonetary transactions to be accounted for at fair value unless (a) fair value is not determinable, (b) the exchange transaction is to facilitate sales to customers, which this Issue interprets, or (c) the exchange transaction lacks commercial substance.

another inventory transaction with the same counterparty, the two are in contemplation of one another and should be combined for purposes of applying Opinion 29. The Task Force also agreed that the issuance of invoices and the exchange of offsetting cash payments is not a factor in determining whether two or more inventory transactions with the same counterparty should be considered as a single nonmonetary inventory transaction within the scope of Opinion 29. The Task Force also reached a tentative conclusion that the following factors may indicate that a purchase transaction and a sales transaction with the same counterparty were entered into in contemplation of one another:

- *There is a legal right of offset of obligations between counterparties involved in inventory purchase and sales transactions.*
  The ability to offset the receivable(s) and payable(s) related to the separately documented inventory transactions indicates that there is a link between them and, therefore, it is an indicator that the separately documented inventory transactions were entered into in contemplation of one another.
- *Inventory purchase and sales transactions with the same counterparty are entered into simultaneously.*
  If an inventory purchase transaction is simultaneously entered into with an inventory sales transaction with the same counterparty, that is an indication that the transactions were entered into in contemplation of one another.
- *Inventory purchase and sales transactions were at off-market terms.*
  If a company enters into an off-market inventory transaction with a counterparty, then it is an indication that the transaction is linked to, and entered into, in contemplation of another inventory transaction with that same counterparty. This indicator may be more relevant for transactions with products that have readily determinable market prices, such as exchange-traded commodities, than for transactions with products that are subject to greater discretionary pricing.
- *Relative certainty that reciprocal inventory transactions with the same counterparty will occur.*
  A company may sell inventory to a counterparty and enter into another arrangement with that same counterparty whereby that counterparty may, but is not contractually required to, deliver an agreed-upon inventory amount. The more certain it is that both inventory transactions will occur, the stronger the indication that the two inventory transactions were entered into in contemplation of one another.

8. The Task Force agreed that none of the factors individually are determinative nor is the list all-inclusive.

9. The Task Force agreed that any consensus on this Issue should be applied to transactions completed in reporting periods beginning after March 15, 2006, whether pursuant to arrangements that were in place at the date of initial application of the consensus or arrangements executed subsequent to that date. The carrying amount of the inventory that was acquired under these types of arrangements prior to the initial application of the consensus and that still remains in an entity's statement of financial position at the date of initial application of the consensus should not be adjusted for this consensus. Early application will be permitted in periods for which financial statements have not been issued.

10. The Task Force asked the staff to prepare a draft abstract reflecting the tentative conclusions that were reached by the Task Force at the March 17 and June 15–16, 2005 EITF meetings and to post that draft abstract to the FASB website for public comment. Comments will be considered by the Task Force at the September 14–15, 2005 EITF meeting.

11. The draft abstract reflecting the Task Force's tentative conclusions is attached as Appendix 04-13A.

**Status**

12. Further discussion is expected at a future meeting.

**Appendix 04-13A**

### *EITF Abstracts* (DRAFT[1])

**Issue No. 04-13**

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

**Dates Discussed:** November 17–18, 2004; March 17, 2005; June 15–16, 2005; September 14–15, 2005

**References:** FASB Statement No. 49, *Accounting for Product Financing Arrangements*

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

FASB Statement No. 153, *Exchanges of Nonmonetary Assets*

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)"

## ISSUE

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 (WIP), or finished goods. Questions have been raised about the accounting for those types of transactions.

2. The issues are:

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**[1] 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 those tentative conclusions.**

Issue 1— The circumstances under which two or more inventory transactions with the same counterparty should be viewed as a single nonmonetary transaction within the scope of Opinion 29

Issue 2— Whether there are circumstances under which nonmonetary exchanges of inventory within the same line of business should be recognized at fair value.

3. The scope of this Issue excludes inventory purchase and sales arrangements that (a) are accounted for as derivatives under Statement 133 or (b) involve exchanges of software or exchanges of real estate. The FASB staff observes that this Issue does not address whether transactions that are reported at fair value qualify for revenue recognition.

## EITF DISCUSSION

*Issue 1—The circumstances under which two or more inventory transactions with the same counterparty should be viewed as a single nonmonetary transaction within the scope of Opinion 29.*

4. The Task Force reached a consensus on Issue 1 that inventory purchase and sales transactions with the same counterparty that are entered into in contemplation of one another should be combined for purposes of applying Opinion 29. The Task Force agreed that in situations in which an inventory transaction is legally contingent upon the performance of another inventory transaction with the same counterparty, the two are in contemplation of one another and should be combined for purposes of applying Opinion 29. The Task Force also agreed that the issuance of invoices and the exchange of offsetting cash payments is not a factor in determining whether two or more inventory transactions with the same counterparty should be considered as a single nonmonetary inventory transaction within the scope of Opinion 29. The Task Force also reached a consensus that in situations in which an inventory transaction is not legally contingent upon the performance of another inventory transaction with the same counterparty, the following factors may indicate that a purchase transaction and a sales transaction were entered into in contemplation of one another:

- *There is a legal right of offset of obligations between counterparties involved in inventory purchase and sales transactions.*
  The ability to offset the receivable(s) and payable(s) related to the separately documented inventory transactions indicates that there is a link between them and, therefore, it is an indicator that the separately documented inventory transactions were entered into in contemplation of one another.
- *Inventory purchase and sales transactions with the same counterparty are entered into simultaneously.*
  If an inventory purchase transaction is simultaneously entered into with an inventory sales transaction with the same counterparty, that is an indication that the transactions were entered into in contemplation of one another.
- *Inventory purchase and sales transactions were at off-market terms.*
  If a company enters into an off-market inventory transaction with a counterparty, that is an indication that the transaction is linked to, and entered into, in contemplation of another inventory transaction with that same counterparty. This indicator may be more

relevant for transactions with products that have readily determinable market prices, such as exchange-traded commodities, than for transactions with products that are subject to greater discretionary pricing.

- *Relative certainty that reciprocal inventory transactions with the same counterparty will occur.*

  A company may sell inventory to a counterparty and enter into another arrangement with that same counterparty whereby that counterparty may, but is not contractually required to, deliver an agreed-upon inventory amount. The more certain it is that both inventory transactions will occur, the stronger the indication that the two inventory transactions were entered into in contemplation of one another.

5. The Task Force agreed that none of the factors individually are determinative nor is the list all-inclusive.

6. If two or more inventory transactions are combined for the purposes of applying Opinion 29, an entity should apply the guidance in Issue 2.

*Issue 2—Whether there are circumstances under which nonmonetary exchanges of inventory within the same line of business should be recognized at fair value.*

7. The Task Force reached a consensus on Issue 2 that a nonmonetary exchange whereby an entity transfers finished goods inventory in exchange for the receipt of raw materials or WIP inventory within the same line of business is not an *exchange transaction to facilitate sales to customers* as described in paragraph 20(b) of Opinion 29, as amended by Statement 153,[2] and, therefore, should be recognized by the entity at fair value if (a) fair value is determinable within reasonable limits and (b) the transaction has commercial substance (paragraphs 20 and 21 of Opinion 29). All other nonmonetary exchanges of inventory within the same line of business should be recognized at the carrying amount of the inventory transferred. That is, a nonmonetary exchange within the same line of business involving (a) the transfer of raw materials or WIP inventory in exchange for the receipt of raw materials, WIP, or finished goods inventory or (b) the transfer of finished goods inventory for the receipt of finished goods inventory should not be recognized at fair value.

8. The Task Force also reached a consensus that the classification of inventory as raw materials, WIP, and finished goods for purposes of this Issue should be the same classification that an entity uses for external financial reporting purposes. The Task Force also agreed that an entity should disclose the amount of revenue and costs (or gains and losses) associated with inventory exchanges recognized at fair value.

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[2] Any final consensus on this Issue will be reached after the effective date of Statement 153. Statement 153 amends Opinion 29 to require nonmonetary transactions to be accounted for at fair value unless (a) fair value is not determinable, (b) the exchange transaction is to facilitate sales to customers, which this Issue interprets, or (c) the exchange transaction lacks commercial substance.

**Transition**

9. The Task Force agreed that the consensus in this Issue should be applied to transactions completed in reporting periods beginning after March 15, 2006, whether pursuant to arrangements that were in place at the date of initial application of the consensus or arrangements executed subsequent to that date. The carrying amount of the inventory that was acquired under these types of arrangements prior to the initial application of the consensus and that still remains in an entity's statement of financial position at the date of initial application of the consensus should not be adjusted for this consensus. Early application is permitted in periods for which financial statements have not been issued.

**Board Ratification**

10. At its [September 28, 2005] meeting, the Board ratified the consensus reached by the Task Force in this Issue.

**STATUS**

11. No further EITF discussion is planned.

**Issue No.** 05-1

**Title:** Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option

**Dates Discussed:** March 17, 2005; June 15–16, 2005

**References:** FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*

FASB Statement No. 84, *Induced Conversions of Convertible Debt*

FASB Statement 128, *Earnings per Share*

FASB Technical Bulletin No. 80-1, *Early Extinguishment of Debt through Exchange for Common or Preferred Stock*

APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*

APB Opinion No. 26, *Early Extinguishment of Debt*

AICPA Accounting Interpretation 1, *Debt Tendered to Exercise Warrants*, of APB Opinion No. 26

**Introduction**

1. At the September 29–30, 2004 EITF meeting, a consensus was reached on EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share." The contingently convertible instruments (CoCos) addressed in Issue 04-8 also may contain an embedded issuer call option that, upon exercise, permits conversion of an instrument by the holder even when the instrument's market price trigger has not been met. Although this Issue was raised in the context of CoCos with market price triggers, it also extends beyond market price triggers to any situation in which a call option permits conversion of an instrument by the holder that is not otherwise convertible or not otherwise currently convertible because of a contingency other than the passage of time. These call options provide the issuer with the ability to call the debt at any time (excluding lock-out periods). The holder has the flexibility to receive cash for the call price or equity. The holder typically will choose to receive equity if the conversion ratio is at a premium to the call price of the debt. Therefore, if the issuer prefers to settle the debt in shares, it may call the debt anytime before maturity (including days before maturity), and if the conversion ratio is at a premium to the call amount of the debt, the instrument holder typically will elect to convert the debt to equity.

2. To illustrate the underlying issue, consider the following two examples:

**Example 1**

An entity issues a debt instrument with a $1,000 par amount and a maturity date of December 31, 2020. The issuer can call the debt at par anytime between 2009 and the maturity date of the debt. If the issuer calls the debt, the holder has the option to receive cash for the par amount of the debt or a fixed number of shares. If the issuer does not call the debt, the holder does not have a conversion option and will receive cash at maturity.

**Example 2**
An entity issues a contingently convertible debt instrument with a market price trigger, a $1,000 par amount, and a maturity date of December 31, 2020. The debt instrument is convertible at the option of the holder if the share price of the issuer exceeds a specified amount. The issuer can call the debt at any time between 2009 and the maturity date of the debt. If the issuer calls the debt, the holder has the option to receive cash for the call amount or a fixed number of shares, regardless of whether the market price trigger has been met.

**Issue**

3. The issue is how the conversion of an instrument that becomes convertible upon the issuer's exercise of a call option should be accounted for.

**Prior EITF Discussion**

4. At the March 17, 2005 EITF meeting, the Task Force reached a tentative conclusion that no gain or loss should be recognized upon the conversion of an instrument that becomes convertible as a result of an issuer's exercise of a call option pursuant to the original terms of the instrument. The Task Force based its tentative conclusion on the fact that Opinion 26 does not apply to debt that is converted to equity of the issuer based on conversion privileges that were included in the terms of the instrument.

5. The Task Force asked the FASB staff to consider the earnings per share treatment for these instruments before the exercise of the call option and provide examples to compare that treatment with the earnings per share treatment for instruments with similar terms. These examples also are to illustrate the application of Opinion 26 to these similar instruments. The FASB staff provided the Task Force with these examples for the June 15–16, 2005 EITF meeting.

**Current EITF Discussion**

6. At the June 15–16, 2005 EITF meeting, the Task Force discussed the previous tentative conclusion, but was not asked to reach a consensus. Certain Task Force members proposed alternatives that would result in either debt conversion or extinguishment accounting depending on whether the shares underlying the conversion were included in diluted earnings per share before the issuer exercised its call. Other Task Force members proposed alternatives based on whether the instruments could be converted due to factors that were not within the control of the issuer. The Task Force asked the FASB staff to research these alternatives for consideration by the Task Force at the September 14–15, 2005 EITF meeting.

**Status**

7. Further discussion is expected at a future meeting.

**Issue No.** 05-2

**Title:** The Meaning of "Conventional Convertible Debt Instrument" in EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"

**Date Discussed:** June 15–16, 2005

**References:** FASB Statement No. 123 (revised 2004), *Share-Based Payment*

FASB Statement No. 129, *Disclosure of Information about Capital Structure*

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

FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*

SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"*

## Introduction

1. Paragraph 12 of Statement 133 provides guidance on the bifurcation of embedded derivatives within a host contract (for example, bonds, insurance policies, and leases) that do not meet the definition of a derivative in its entirety. Specifically, subparagraph 12(c) of Statement 133 indicates that one of the three necessary criteria for bifurcation is that "a separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement."[1]

2. Paragraph 11 of Statement 133 provides guidance to identify those contracts that should not be considered and accounted for as derivative instruments. Specifically, paragraph 11(a) of Statement 133 indicates that "contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position" should not be considered derivative instruments.

3. EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," provides guidance in determining whether an embedded derivative would be classified in stockholders' equity in accordance with paragraph 11(a) of Statement 133 if it were freestanding. During its deliberations of Issue 00-19, the Task Force decided to include, in paragraph 4, an exception to the criteria in paragraphs 12–32 when evaluating whether a "conventional convertible debt instrument" in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the

[1] The other two criteria in Statement 133 are (a) the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract and (b) the contract that embodies both the embedded derivative and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.

issuer) contains an embedded derivative indexed to the company's own stock that would require bifurcation.

4. The variety of contractual terms included in convertible debt instruments has increased dramatically since the Task Force deliberated Issue 00-19. These contractual terms include, but are not limited to, contingent conversion features (including single or multiple triggers), variable conversion ratios, and call options. Since the term *conventional convertible debt* is not defined in detail in Issue 00-19, there is diversity in practice in evaluating whether convertible debt instruments containing these features are considered "conventional" for purposes of determining whether the instrument qualifies for the exception provided in paragraph 4 of Issue 00-19.

5. A similar practice issue exists in evaluating whether convertible preferred stock with debt-like features (such as convertible preferred stock with a mandatory redemption date) qualifies for consideration under this exception. In accordance with paragraph A9 of Statement 150, convertible preferred stock with a mandatory redemption date would generally not be classified as a liability because the redemption is contingent upon the holders' not exercising their option to convert the instrument into a fixed number of shares (if conversion was into a variable number of shares, the instrument could be a liability in accordance with Statement 150). For these instruments, SEC registrants are required to follow the guidance in ASR 268 and *EITF Abstracts*, Topic No. D-98, "Classification and Measurement of Redeemable Securities." Accordingly, public companies classify these instruments on the balance sheet between liabilities and permanent equity in a caption commonly referred to as "mezzanine" or "temporary" equity.

**Issues**

6. The issues are:

Issue 1— Whether the exception to the requirements of paragraphs 12–32 of Issue 00-19 for "conventional convertible debt instruments" should be removed or further clarified

Issue 2— Whether a contingency related to the exercise of the conversion option should impact the assessment of whether an instrument is "conventional" for evaluating the exception in paragraph 4 of Issue 00-19

Issue 3— Whether convertible preferred stock with a mandatory redemption date can qualify for the exception included in paragraph 4 of Issue 00-19.

**Current EITF Discussion**

7. At the June 15–16, 2005 EITF meeting, the Task Force reached a consensus on Issue 1 that the exception to the requirements of paragraphs 12–32 of Issue 00-19 for "conventional convertible debt instruments" should be retained and, accordingly, the Task Force considered Issue 2 and Issue 3.

8. On Issue 2, the Task Force reached a consensus that instruments that provide the holder with an option to convert into a fixed number of shares (or equivalent amount of cash at the discretion of the issuer) for which the ability to exercise the option is based on the passage of time or a contingent event should be considered "conventional" for purposes of applying Issue 00-19. Instruments that contain "standard" antidilution provisions would not preclude a conclusion that

the instrument is convertible into a fixed number of shares. Standard antidilution provisions are those that result in adjustments to the conversion ratio in the event of an equity restructuring transaction (as defined in the glossary of Statement 123(R)[2]) that are designed to maintain the value of the conversion option.

9. On Issue 3, the Task Force reached a consensus that convertible preferred stock with a mandatory redemption date may qualify for the exception included in paragraph 4 of Issue 00-19 if the economic characteristics indicate that the instrument is more akin to debt than equity. An entity should consider the guidance in subparagraph 61(l) of Statement 133 in assessing whether the instrument is more akin to debt or equity.[3]

10. For instruments that are within the scope of this Issue, entities should include the applicable disclosures required by Statement 129.

**Transition**

11. The consensus in this Issue should be applied to new instruments entered into and instruments modified in periods beginning after Board ratification of the consensus.

**Board Ratification**

12. At its June 29, 2005 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

**Status**

13. No further EITF discussion is planned.

[2] Statement 123(R) defines an equity restructuring as "a nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying the option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend."

[3] If the preferred stock is more akin to equity than debt, an equity conversion feature would be "clearly and closely related" to that host instrument.

**Issue No.** 05-3

**Title:** Accounting for Rental Costs Incurred during the Construction Period

**Date Discussed:** June 15–16, 2005

**References:** FASB Statement No. 13, *Accounting for Leases*

FASB Statement No. 23, *Inception of the Lease*

FASB Statement No. 34, *Capitalization of Interest Cost*

FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*

FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*

FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*

AICPA Statement of Position 98-5, *Reporting on the Costs of Start-Up Activities*

AICPA Technical Practice Aids, Section 5600, "Leases"

**Introduction**

1. In some lease arrangements, an entity (lessee) may take possession of or be given control of leased property prior to that entity commencing operations or making rental payments under the terms of the lease. The leased property may include both land and building(s). During this period, the lessee has the right to use the leased property and does so for the purpose of constructing a lessee asset (for example, leasehold improvements).

2. Technical Bulletin 88-1 requires rental costs associated with operating leases to be allocated on a straight-line basis to periods beginning when the lessee takes possession of or is given control of the leased property, regardless of when (a) the lessee's operations commence or (b) the lessee is required to make payments under the terms of the lease.[1]

3. For example, on January 1, 2005, a lessee enters into a lease arrangement and is given control of the leased asset in order to construct leasehold improvements (lessee assets) and to otherwise ready the property for the lessee's intended use. The lessee is required to make rental payments to the landlord beginning on July 1, 2005, at which time the lessee is expected to commence operations. In this example, the lessee would allocate rental costs on a straight-line

[1] For purposes of lease classification, *inception of the lease* is defined in Statement 23 as "the date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment shall be in writing, signed by the parties in interest to the transaction, and shall specifically set forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition." The inception of the lease may or may not be the date the lessee is given control of the leased asset.

basis over the lease term beginning on January 1, 2005, because that is the date on which the lessee is given control of the leased asset.

4. Constituents have asked whether rental costs associated with ground and building leases that are incurred during the construction of an asset that is directly related to the leased property (that is, rental costs incurred during the construction period)[2] may be capitalized.

*Scope*

5. This Issue addresses whether an entity may capitalize rental costs that are incurred during the construction period and, if so, the types of rental costs that are capitalizable. This Issue does not address rental costs other than those associated with building and ground operating leases.

**Issue**

6. The issue is whether an entity may capitalize rental costs associated with ground and building operating leases that are incurred during the construction period.

**Current EITF Discussion**

7. At the June 15–16, 2005 EITF meeting, the Task Force discussed whether rental costs that are incurred during the construction period may be capitalized. The Task Force considered three alternatives: (a) building and ground rental costs incurred during the construction period may be capitalized, (b) building and ground rental costs incurred during the construction period must be expensed, and (c) only ground rental costs incurred during the construction period may be capitalized. The Task Force was unable to reach a consensus and agreed to remove this Issue from its agenda. The FASB staff observed that an entity can change its accounting policy for rental costs incurred during construction only when such a change is considered preferable.

**Status**

8. At its June 29, 2005 meeting, the Board agreed to provide guidance through an FASB Staff Position on whether an entity may capitalize rental costs associated with ground and building operating leases that are incurred during construction. No further EITF discussion is planned.

[2] *Rental costs incurred during the construction period* refers to those costs that are allocated to the construction period.

**Issue No.** 05-4

**Title:** The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"

**Date Discussed:** June 15–16, 2005

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

FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*

Statement 133 Implementation Issue No. K-1, "Determining Whether Separate Transactions Should Be Viewed as a Unit"

## Introduction

1. A financial instrument subject to the provisions of EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," such as stock purchase warrants, may be issued at the same time and in contemplation of a registration rights agreement that includes a liquidated damages clause. Typically, the registration rights agreement requires the issuer to use its "best efforts" to file a registration statement for the resale of the instruments themselves or the shares of stock underlying the instruments (as well as shares or other convertible securities sold to the investors) and to have the registration statement declared effective by the end of a specified grace period. In some registration rights agreements, the issuer may also be required to maintain the effectiveness of the registration statement for a period of time. If the issuer fails to have the registration statement declared effective within the grace period (or if effectiveness is not maintained), the registration rights agreement requires the payment of liquidated damages to the investor until the registration statement is declared effective or effectiveness is maintained for a prescribed period (or, in some cases, until the investor is no longer incurring damages for the issuer's failure to register the securities; for example, if the securities become freely transferable after a holding period under Rule 144 of the Securities Act of 1933).

2. The liquidated damages penalty in a registration rights agreement typically is paid in cash and the amount is determined by a formula, such as a percentage of the amount paid for the securities that were issued.[1] The penalty generally ranges from 0.25 percent to 2 percent per month for the period following the grace period that the specific shares remain unregistered, with no stated cap or maximum penalty specified in the agreement. The grace period within which the registration statement must be filed and declared effective is generally 90 to 180 days from the date the financial instrument is originally issued. Therefore, if the liquidated damages penalty is 1 percent of the issuance price of a warrant per month with no limit and the grace period is 180 days for a warrant with a 5-year term, the issuer could be obligated to pay as much

[1] In a convertible debt arrangement, the penalty may be an increase to the annual yield on the convertible note.

as 54 percent of the issuance price of the warrant for failure to have the shares registered. (The liquidated damages penalty is computed based on the 60-month term, less a 6-month grace period, times 1 percent per month.)

3. Because some believe that the registration rights agreement with the penalty clause meets the definition of a derivative,[2] and given the potential significance of the maximum liquidated damages penalty in a registration rights agreement, a question arises as to the effect, if any, this agreement has on the accounting for the related financial instruments that are subject to the provisions of Issue 00-19. That is, there is diversity in practice as to whether the registration rights agreement and the financial instrument are viewed as one combined freestanding instrument or accounted for as separate freestanding instruments. Further, if the agreements are viewed as a unit, practice also is diverse regarding the assessment of the unit under Issue 00-19 and EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock.'"

**Issue**

4. The issue is how a liquidated damages clause payable in cash affects the accounting for a freestanding financial instrument subject to the provisions of Issue 00-19.

**Current EITF Discussion**

5. At the June 15–16, 2005 EITF meeting, the Task Force discussed (a) whether a registration rights penalty meets the definition of a derivative and (b) whether the registration rights agreement and the financial instrument to which it pertains should be considered as a combined freestanding instrument or as separate freestanding instruments. Additionally, some Task Force members expressed a preference for evaluating a liquidated damages provision based on the probable amount that the issuer would pay rather than the maximum amount. The Task Force was not asked to reach a consensus on this Issue. The Task Force asked the FASB staff to obtain additional information about how entities currently evaluate and account for registration rights agreements in practice. Additionally, the Task Force asked the FASB staff to analyze registration rights penalties in comparison with other penalties that do not meet the definition of a derivative.

**Status**

6. Further discussion is expected at a future meeting.

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[2] Some believe that the instrument (registration rights agreement) has an underlying (the occurrence or nonoccurrence of an event—whether or not the shares become registered), requires no initial net investment, and will be net settled with the holder (the cash payment of the penalty is associated with the underlying but not equal to the notional amount of the contract).

**Issue No.** 05-5

**Title:** Accounting for Early Retirement or Postemployment Programs with Specific Features (Such As Terms Specified in Altersteilzeit Early Retirement Arrangements)[1]

**Date Discussed:** June 15–16, 2005

**References:** FASB Statement No. 43, *Accounting for Compensated Absences*

FASB Statement No. 87, *Employers' Accounting for Pensions*

FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*

FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*

FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*

FASB Statement No. 154, *Accounting Changes and Error Corrections*

FASB Staff Position FAS 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003"

APB Opinion No. 12, *Omnibus Opinion—1967*

## Introduction

1. The Altersteilzeit (ATZ) arrangement is an early retirement program in Germany designed to create an incentive for employees, within a certain age group, to transition from (full or part-time) employment into retirement before their legal retirement age. The program was created by legislation in 1996 and through subsequent extensions is now scheduled to expire in 2009. Employers taking advantage of this legislation must sign a contract under the legal framework outlined in the legislation with the workers' council/unions or with the individual employees (employees not within a workers' council/union) to qualify for subsidies from the government. The German government provides a subsidy (reimbursement) to an employer for the bonuses paid to the employee and the additional contributions paid into the German government pension scheme under an ATZ arrangement for a maximum of six years. To receive this subsidy, an employer must meet certain criteria (typically, an employer must hire replacement employees from currently registered unemployed persons or former trainees).

## Scope

2. This Issue addresses specific features in ATZ arrangements. Any consensus reached in this Issue may apply to other types of benefit arrangements with the same or similar terms.

## Background

3. Typical features of an ATZ arrangement include the following:

[1] Formerly entitled, "Accounting for the Altersteilzeit Early Retirement Programs."

- To enroll in an ATZ arrangement, an employee must sign an ATZ contract with the employer. The employee can sign the ATZ contract before being eligible to begin working under the ATZ arrangement. An employee may begin working under the ATZ arrangement only upon attaining the age such that upon completion of the ATZ period,[2] he/she will be eligible for the normal government retirement benefits (typically 63 years old for men and 62 years old for women).

- An employer is required to allow participation in the ATZ arrangement without restriction until participation reaches 5 percent of the total work force. After 5 percent participation is achieved, an employer has, at its discretion, the right to determine whether employees are accepted into the ATZ arrangement.[3]

- In most cases, an employee is required to work for a minimum period of time with any employer before being eligible for the ATZ arrangement; prior employment with the present employer is not necessary.

- The arrangement typically offers two alternative arrangements for participating employees:

    - Type I: participant works 50 percent of the normal full-time schedule for each year of the entire ATZ period and receives 50 percent of his/her salary each year.
    - Type II: participant works full-time for half of the ATZ period (the "active period"), and then does not work for the remaining half (the "inactive period"), and receives 50 percent of his/her salary each year during the entire ATZ period.
    - Under both alternatives, participants receive an annual bonus, which varies by employer, but will generally equal 10–15 percent of their most recent regular pay before the start of the ATZ period; thus, the regular combined paid compensation will normally equal about 60–65 percent of the participant's most recent regular pay prior to the start of the ATZ period. The employer also will make additional contributions into the German government pension scheme for participants (to compensate for the fact that the employee has not been working at his/her previous level during the ATZ period) during the entire ATZ period.[4]

- Employees must provide service to the employer for the required portion of the ATZ period (the active period) to receive the full bonus. If a participant dies, voluntarily leaves the company, or is otherwise terminated before fulfilling the service period

[2] ATZ period consists of the period from when the employee begins to work under the ATZ arrangement until the employee is no longer under a legal work arrangement with the employer (terminated from the company). This period is generally one to six years, depending on the specific ATZ arrangement and the age of the participant.
[3] However, in some situations, a lower "mandatory participation" cap is agreed to between an employer and the workers' council.
[4] Contributions into the German government pension scheme (as well as length of service) determine the amount of pension benefits the employee will receive from that scheme. Therefore, by making additional contributions into the German government pension scheme during the entire ATZ period, the pension benefits paid to the employees will be higher than they would have been had the contributions been based solely on the employees' active service during the ATZ period.

requirement, the ATZ contract will be unwound and the total compensation received by the participant will be adjusted to the amount that the participant would have received if he/she had not participated in the ATZ arrangement (salary is contractually set at the amount the employee earned just before the ATZ period). For example, if an employee enters into a four-year Type II ATZ arrangement and leaves the company after one year, the employee will receive (for the one year worked) all of his/her pre-ATZ period annual salary and will not receive any ATZ bonus.

- During the inactive period under the Type II ATZ arrangement, participants are legally under a work contract with the employer (considered employees); however, an employee is not permitted to return to active work. Otherwise, the employer would lose any government subsidy.

- Under the Type I arrangement, the employer can claim the subsidy for a replacement worker hired during the entire ATZ period. Under the Type II arrangement, an employer could only claim the subsidy for a replacement worker hired during the inactive ATZ period. Therefore, under the Type II arrangement, the reimbursement each year during the inactive period would be equivalent to two years of (1) bonus payments and (2) additional contributions made into the German government pension scheme.

**Issues**

4. The issues are:

Issue 1— How to account for the bonus feature and additional contributions into the German government pension scheme under a Type II ATZ arrangement

Issue 2— How to account for the government subsidy under Type I and Type II ATZ arrangements.

**Current EITF Discussion**

5. At the June 15–16, 2005 EITF meeting, the FASB staff observed that the salary components of Type I and Type II ATZ arrangements (excluding the bonus and additional contributions into the German government pension scheme) should be recognized over the period from the point at which the ATZ period begins until the end of the active service period. Additionally, the portion of the salary that is deferred under a Type II arrangement should be discounted if payment is expected to be deferred for a period longer than one year. The Task Force agreed with these FASB staff observations.

6. On Issue 1, the Task Force reached a consensus that the bonus feature and the additional contributions into the German government pension scheme (collectively, the additional compensation) under a Type II ATZ arrangement should be accounted for as a postemployment benefit under Statement 112. An entity should recognize the additional compensation over the period from the point at which the employee signs the ATZ contract until the end of the active service period.

7. The Task Force reached a consensus on Issue 2 that the employer should recognize the government subsidy when it meets the necessary criteria and is entitled to the subsidy.

**Transition**

8. The consensus in this Issue should be applied to fiscal years beginning after December 15, 2005, and reported as a change in accounting estimate effected by a change in accounting principle as described in paragraph 19 of Statement 154. A company should provide the disclosures required by paragraph 22 of Statement 154.

**Board Ratification**

9. At its June 29, 2005 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

**Status**

10. No further EITF discussion is planned.

**Issue No.** 05-6

**Title:** Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination

**Date Discussed:** June 15–16, 2005

**References:** FASB Statement No. 13, *Accounting for Leases*

FASB Statement No. 98, *Accounting for Leases*

FASB Statement No. 141, *Business Combinations*

FASB Statement No. 142, *Goodwill and Other Intangible Assets*

FASB Interpretation No. 21, *Accounting for Leases in a Business Combination*

APB Opinion No. 12, *Omnibus Opinion—1967*

International Accounting Standard 16, *Property, Plant and Equipment*

International Accounting Standard 17, *Leases*

**Introduction**

1. Statement 13 requires that a lessee determine the *lease term* at the inception of a lease. Paragraph 5(f) of Statement 13 defines lease term as the fixed noncancelable term of the lease plus all periods covered by bargain renewal options or for which failure to renew the lease imposes a penalty on the lessee in such an amount that a renewal appears to be reasonably assured. *Penalty*, as used in the definition of lease term, is discussed in paragraph 5(o) of Statement 13. Factors to consider in evaluating whether a penalty would be incurred if the lessee failed to renew include "the uniqueness of purpose or location of the property, the availability of a comparable replacement property, the relative importance or significance of the property to the continuation of the lessee's line of business… [and] the *existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property*…" (emphasis added).

2. Once the lease term (including renewals that are deemed reasonably assured) is determined, an entity can then determine (a) the classification of the lease (capital versus operating) and (b) the period to recognize straight-line rents.

3. Paragraph 11(b) of Statement 13 requires that assets recognized under capital leases (and in which the lease does not (a) transfer ownership of the property to the lessee at the end of the lease term or (b) contain a bargain purchase option) be amortized in a manner consistent with the lessee's normal depreciation policy except that the amortization period is limited to the lease term (which includes renewal periods that are reasonably assured). In other words, a lessee should expect that it will not control assets recognized under capital leases in periods that are not reasonably assured of renewal. Therefore, the lessee cannot expect to receive any economic benefits from those assets in periods that are not reasonably assured of renewal. While the amortization period of leasehold improvements for operating leases is not addressed in Statement

13, practitioners generally analogize to the guidance provided in paragraph 11(b) of that Statement. This analogy is generally accepted because, similar to assets recognized under capital leases, an entity should expect that it will not control leasehold improvements in periods that are not reasonably assured of renewal and, therefore, the lessee cannot expect to receive any economic benefits from those assets in periods that are not reasonably assured of renewal. Accordingly, practice has evolved such that leasehold improvements placed in service (or contemplated) at or near the beginning of the initial lease term are amortized over the lesser of the leasehold improvement's useful life or the lease term.

4. Questions have been raised about the determination of the amortization period for leasehold improvements that are placed in service significantly after and not contemplated at or near the beginning of the initial lease term. Paragraph 9 of Statement 13 states that the lease term for purposes of lease classification cannot be changed unless either (a) the provisions of the lease are modified in a manner that results in the lease being considered a new agreement or (b) the lease is extended or renewed beyond the existing lease term. Therefore, practitioners question whether the amortization period for leasehold improvements that are placed in service significantly after and not contemplated at or near the beginning of a lease can extend beyond the lease term that was determined at lease inception.

5. A similar question has been raised about leases assumed in a business combination. As part of a business combination, the acquiring entity may assume existing lease agreements of the acquired entity and acquire the related leasehold improvements. Paragraphs 12 and 13 of Interpretation 21 require that the acquiring entity retain the lease classification used by the acquired entity, unless one of the conditions of paragraph 9 of Statement 13 is met. Therefore, practitioners question whether the amortization period for leasehold improvements acquired in a business combination can extend beyond the lease term that was determined by the acquiree at lease inception.

*Scope*

6. This Issue addresses the amortization period for leasehold improvements in operating leases that are either (a) placed in service significantly after and not contemplated at or near the beginning of the initial lease term or (b) acquired in a business combination. This Issue does not address the amortization of intangible assets that may be recognized in a business combination for the favorable or unfavorable terms of a lease relative to market prices. The objective of the Board's current project Useful Life and Amortization of Intangible Assets is to provide guidance on certain aspects of the determination of the useful life and amortization of renewable intangible assets under Statement 142.

**Issues**

7. The issues are:

Issue 1— The amortization period for leasehold improvements acquired in a business combination

Issue 2— The amortization period of leasehold improvements that are placed in service significantly after and not contemplated at the beginning of the lease term.

**Current EITF Discussion**

8. At the June 15–16, 2005 EITF meeting, the Task Force reached a consensus on Issue 1 that leasehold improvements acquired in a business combination should be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured (as defined in paragraph 5 of Statement 13) at the date of acquisition.

9. The Task Force reached a consensus on Issue 2 that leasehold improvements that are placed in service significantly after and not contemplated at or near the beginning of the lease term should be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured (as defined in paragraph 5 of Statement 13) at the date the leasehold improvements are purchased.

10. The Task Force discussed whether the amortization period for an existing leasehold improvement should be reevaluated after the initial determination of the amortization period but was not asked to reach a consensus. The Task Force directed the FASB staff to further develop that issue and present it to the EITF Agenda Committee for consideration as a separate Issue for the EITF's agenda.

**Transition**

11. The consensus should be applied to leasehold improvements (within the scope of this Issue) that are purchased or acquired in reporting periods beginning after Board ratification of the consensus. Early application of the consensus is permitted in periods for which financial statements have not been issued.

**Board Ratification**

12. At its June 29, 2005 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

**Status**

13. No further EITF discussion is planned.

## 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 September 14–15, 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 |
|---|---|---|---|---|---|---|---|
| 04-13 | Accounting for Purchases and Sales of Inventory with the Same Counterparty | 11/04 | 11/04, 3/05, 6/05 | 9/05 | Geary/ Oakley/ Belcher | A draft abstract will be posted to the FASB website for public comment by July 7, 2005. The Task Force will consider the comments received at the September 2005 meeting. | September meeting materials |
| 05-1 | Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option | 11/04 | 3/05, 6/05 | 9/05 | Oakley/ Sarno | The FASB staff will prepare an Issue Summary for the September 2005 meeting. | September meeting materials |

| Issue No. | Description | Date Added | Date(s) Discussed | Next Meeting | FASB Staff | Immediate Plans | Due Date - Next Deliverable |
|---|---|---|---|---|---|---|---|
| 05-4 | The Effect of a Liquidated Damages Clause on a Financial Instrument Subject to EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" | 2/05 | 6/05 | 9/05 | Thuener/ Jacobs/ Richards | The FASB staff will prepare an Issue Summary for the September 2005 meeting. | September meeting materials |
| 05-F | Accounting for Modifications to Conversion Options Embedded in Debt Securities and Related Issues | 5/05 | N/A | 9/05 | Cosper/ Jacobs | The FASB staff will prepare an Issue Summary for the September 2005 meeting. | September meeting materials |
| 05-G | Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature | 5/05 | N/A | 9/05 | Beswick/ Sarno | The FASB staff will prepare an Issue Summary for the September 2005 meeting. | September 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 | Sarno | The FASB staff will ask the EITF Agenda Committee whether the staff should reinitiate work on this Issue considering the Board's recent decision to delay Phase II of the Board's share-based payments project. | The EITF Agenda Committee will consider at its next meeting. |
| | *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.* | | | | | | |
| 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 | 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 | Jacobs | 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)<br>11/02 (TF) | N/A | Not scheduled | 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 | Moss | 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 |
| 04-7 | Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity | 5/04 | 6/04, 9/04, 11/04, 3/05 | 9/05 | Belcher | At its March 30, 2005 meeting, the Board agreed to add a project to provide guidance on the variability that should be considered when determining whether an interest is a variable interest.  The FASB staff will ask the Task Force to remove this Issue from its agenda at the September 2005 meeting. | 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 | Jacobs | 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 |