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FINANCIAL ACCOUNTING STANDARDS BOARD
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October 4, 2005

TO: MEMBERS OF THE FASB EMERGING ISSUES TASK FORCE

Included are the final minutes of the September 15, 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 September 30 draft. After your review, please discard the confidential marked version of the minutes.

November Meeting Time and Location
The next EITF meeting will be held on **Thursday, November 10, 2005,** at the FASB offices in Norwalk, Connecticut. Based on our preliminary thoughts on the agenda, the meeting will start at **10:00 a.m.** and conclude no later than **3:00 p.m.**

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

Draft minutes available	**November 15, 2005**
Final minutes available	**November 30, 2005**

Agenda Committee Meeting
The next Agenda Committee meeting will be held on October 10, 2005. Materials for the meeting will be sent out shortly.

Please call me at extension x211 if you have any questions.

Sincerely,

James W. Geary
Practice Fellow
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(203) 956-5211

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**MINUTES OF THE SEPTEMBER 15, 2005 MEETING
OF THE FASB EMERGING ISSUES TASK FORCE**

Location: FASB Offices
401 Merritt 7
Norwalk, Connecticut

Thursday, September 15, 2005
Starting Time: 10:00 a.m.
Concluding Time: 2:58 p.m.

Task Force Members Present:
Lawrence W. Smith (Chairman)
Mark M. Bielstein
*Frank H. Brod (by phone)
Jack T. Ciesielski
Mitchell A. Danaher
Leland E. Graul
Joseph F. Graziano
Stuart H. Harden
Jan R. Hauser
David L. Holman
James A. Johnson
Carl Kampel
Matthew L. Schroeder
Ashwinpaul C. (Tony) Sondhi
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
James W. Geary, FASB Practice Fellow
Shelly C. Luisi, SEC Senior Associate Chief Accountant
Robert Uhl, Deloitte & Touche LLP, Rotating AcSEC Observer
* Steven P. Belcher, FASB Practice Fellow
* Paul A. Beswick, FASB Practice Fellow
* Susan M. Cosper, FASB Practice Fellow
* Jason L. Jacobs, FASB Practice Fellow
* Reginald D. Oakley, FASB Practice Fellow
* John L. Sarno, FASB Practice Fellow

* For certain issues only.

ADMINISTRATIVE MATTERS

- Prior Meeting Minutes. An FASB staff member solicited objections to the final minutes of the June 15–16, 2005 meeting. No objections were noted.

- Hurricane Katrina Accounting Guidance. The Task Force Chairman announced that neither the FASB nor the EITF intend to provide specific accounting guidance for the events related to Hurricane Katrina. However, the Chairman indicated that the AICPA has posted to its website, a Technical Practices Aid that identifies certain issues related to accounting for losses from natural disasters and that the FASB website will provide a link to that document. AICPA Technical Practices Aid 5400.05, "Accounting and Disclosures for Losses from Natural Disasters—Nongovernmental Entities," addresses, through references to other appropriate accounting literature on the subject, whether a natural disaster should be classified as an extraordinary event, when to recognize losses for asset impairments and liabilities for non-impairment losses and costs, and the accounting for insurance recoveries.

The Chairman also indicated that the FASB staff has received inquires from some banking regulators regarding the unprecedented increase in the demand for loans, withdrawals of deposits, and other needs for cash being experienced by some financial institutions in the gulf coast and the FASB staff's views as to whether the institutions can sell held-to-maturity (HTM) securities to meet these cash needs without tainting the remaining HTM portfolio. The Chairman reported that the last two sentences of paragraph 8 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* addresses other unusual circumstances that cannot be reasonably anticipated where the sale of HTM securities would not necessarily call into question an entity's intent to hold other debt securities to maturity and the FASB staff's view that, for some entities, Hurricane Katrina would appear to meet that provision.

- The Task Force discussed the report on the EITF Agenda Committee meeting held on August 2, 2005. The following decision was made by the Agenda Committee:

a. *Reevaluation of the Amortization Period for Preexisting Leasehold Improvements to Consider Additional Renewal Periods When New Leasehold Improvements Are Placed into Service Significantly after and Are Not Contemplated at or near the Beginning of the Lease Term*. The Agenda Committee decided not to add this issue to the EITF Agenda. Rather, the Agenda Committee proposed that the Task Force clarify that the consensus in EITF Issue No. 05-6, "Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination," does not apply to preexisting leasehold improvements. Refer to the discussion of the Issue 05-6 consensus modification elsewhere in these minutes.

- The FASB staff reported that the Task Force will postpone further deliberations on EITF Issue No. 05-4, "The Effect of a Liquated 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,'" which was last discussed at the June 15–16, 2005 EITF meeting, until after the Board addresses whether a separate registration rights agreement, as discussed in Issue 05-4, is a derivative. The FASB staff will request that the Board consider a separate DIG issue that addresses whether a registration rights agreement is a derivative in accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Following the resolution of that DIG issue, the FASB staff will request that the Task Force reconvene EITF deliberations on Issue 05-4.

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

a. EITF Issue No. 04-6, "Accounting for Stripping Costs Incurred during Production in the Mining Industry " (Comment Letter No. 4)

b. EITF Issue No. 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty" (Draft Abstract, Comment Letters Nos. 1-3)[1]

c. EITF Issue No. 05-3, "Accounting for Rental Costs Incurred during the Construction Period" (Comment Letter No. 8)

d. EITF Issue No. 05-5, "Accounting for Early Retirement or Postemployment Programs with Specific Features (Such As Terms Specified in Altersteilzeit Early Retirement Arrangements)" (Comment Letter No. 1).

- The Task Force Chairman welcomed Mr. Matthew L. Schroeder, The Goldman Sachs Group, and Mr. Carl Kampel, Ellin & Tucker, Chartered, as members of the Task Force representing the financial statement preparer and public accounting firm constituencies, respectively.

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

- 2006 EITF Meeting Dates. The FASB staff formally confirmed the following EITF meeting dates for 2006:

January 6, 2006
March 15–16, 2006
June 14–15, 2006
September 6–7, 2006
November 15–16, 2006.

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

- November 2005 EITF Meeting: The FASB staff asked Task Force members to anticipate a day-and-a-half EITF meeting to be held on November 9–10, 2005. However, the Chairman noted that, depending on the outcome of the September EITF meeting and the receipt of additional agenda requests, the November meeting could be cancelled.

- The Task Force held a closed administrative session to discuss updates to the EITF Operating Procedures. The EITF Operating Procedures will be posted to the FASB website in the near future.

CONSENSUS MODIFICATION

Issue No. 05-6

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

Date Discussed: September 15, 2005

The consensus in Issue 05-6 was reached at the June 15–16, 2005 EITF meeting. However, during its deliberations of that Issue, 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 potential issue for the EITF Agenda.

At its meeting on August 2, 2005, the EITF Agenda Committee decided not to add the proposed issue "Reevaluation of the Amortization Period for Preexisting Leasehold Improvements to Consider Additional Renewal Periods When New Leasehold Improvements Are Placed into Service Significantly after and Are Not Contemplated at or near the Beginning of the Lease Term," to the EITF Agenda. Rather, the Agenda Committee agreed to propose that the Task Force clarify that the consensus in Issue 05-6 does not apply to preexisting leasehold improvements. Therefore, the consensus in Issue 05-6 should not be used to justify the reevaluation of the amortization period for preexisting leasehold improvements for additional renewal periods that are reasonably assured when new leasehold improvements are placed into service significantly after and are not contemplated at or near the beginning of the lease term.

The Task Force agreed to modify the consensus in Issue 05-6 by including the following paragraph in the Status section of the abstract:

> At the September 15, 2005 EITF meeting, the Task Force agreed to clarify that the consensus in Issue 05-6 does not apply to preexisting leasehold improvements. Therefore, the consensus in Issue 05-6 should not be used to justify the reevaluation of the amortization period for preexisting leasehold improvements for additional renewal periods that are reasonably assured when new leasehold improvements are placed into service significantly after and are not contemplated at or near the beginning of the lease term.

Board Ratification

At its September 28, 2005 meeting, the Board ratified the modification to the consensus in this Issue.

REVISED SEC STAFF ANNOUNCEMENT

Topic: Revisions to *EITF Abstracts*, Topic No. D-98, "Classification and Measurement of Redeemable Securities"

Date Discussed: September 15, 2005

The SEC staff announced the following changes to Topic D-98, which is duplicated below in its entirety with paragraph numbers added (additions are underscored and deletions are struck through).

Topic No. D-98

Topic: Classification and Measurement of Redeemable Securities

Dates Discussed: July 19, 2001; May 15, 2003; March 17–18, 2004<u>; September 15, 2005</u>

1. The SEC staff has received inquiries about the financial statement classification and measurement of securities subject to mandatory redemption requirements or whose redemption is outside the control of the issuer. [Note: See Subsequent Developments section below.]

Scope

2. Rule 5-02.28 of Regulation S-X[1] requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer. Although the rule specifically describes and discusses preferred securities, the SEC staff believes that Rule 5-02.28 of Regulation S-X also provides analogous guidance for other equity instruments including, for example, common stock and derivative instruments that are classified as equity pursuant to Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

[1] Adopted in Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks."*

3. As noted in Accounting Series Release No. 268 (ASR 268), the Commission reasoned that "[t]here is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The Commission believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital."[2] Upon a reporting entity's adoption of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* certain instruments that previously were reported as part of shareholder's equity (including temporary equity) will be reported as liabilities. [Note: See Subsequent Developments section below.] Consequently, the presentation requirements outlined in ASR 268 (Rule 5-02.28 of Regulation S-X), and the interpretive guidance in this staff announcement, do not apply to those instruments after the effective date of Statement 150. ASR 268 and the interpretive guidance in this staff announcement continue to be applicable for instruments that are not within the scope of Statement 150.

Classification

4. Rule 5-02.28 of Regulation S-X requires securities with redemption features that are not solely within the control of the issuer to be classified outside of permanent equity. The SEC staff believes that all of the events that could trigger redemption should be evaluated separately and that the possibility that *any* triggering event that is not *solely* within the control of the issuer could occur—without regard to probability—would require the security to be classified outside of permanent equity.

5. The SEC staff believes that ordinary liquidation events, which involve the redemption and liquidation of all equity securities, should not result in a security being classified outside of permanent equity. In other words, if the payment of cash is required only upon final liquidation of the company, then that potential event need not be considered when applying the rule. However, deemed liquidation events that require one or more particular class or type of equity security to be redeemed cause those securities to be classified outside of permanent equity.

6. Determining whether an equity security is redeemable at the option of the holder or upon the occurrence of an event that is solely within the control of the issuer can be complex. Accordingly, the SEC staff believes that all of the individual facts and circumstances should be considered in determining how an equity security should be classified.

[2] See ASR 268, July 27, 1979.

Examples in which permanent equity classification is not appropriate

7. Assume that a preferred security has a redemption provision that states it may be called by the issuer upon an affirmative vote by the majority of its board of directors. While some might view the decision to call the security as an event that is within the control of the company, the SEC staff believes that if the preferred security holders control a majority of the votes of the board of directors through direct representation on the board of directors or through other rights, the preferred security is redeemable at the option of the holder and its classification outside of permanent equity is required. In other words, any provision that requires approval by the board of directors cannot be assumed to be within the control of the issuer. All of the relevant facts and circumstances must be considered.

8. In another example, consider a security with a deemed liquidation clause that provides that the security becomes redeemable if the stockholders of the issuing company (that is, those immediately prior to a merger or consolidation) hold, immediately after such merger or consolidation, stock representing less than a majority of the voting power of the outstanding stock of the surviving corporation. This change-in-control provision would require the security to be classified outside of permanent equity because a purchaser could acquire a majority of the voting power of the outstanding stock, without company approval, thereby triggering redemption.

9. Securities with provisions that allow the holders to be paid upon the occurrence of events that are not solely within the issuer's control should be classified outside of permanent equity. Such events include:

- The failure to have a registration statement declared effective by the SEC by a designated date
- The failure to maintain compliance with debt covenants
- The failure to achieve specified earnings targets
- A reduction in the issuer's credit rating.

Examples in which permanent equity classification is appropriate

10. Other events are solely within the control of the issuer, and, accordingly, classification as part of permanent equity would be appropriate. For example, a preferred stock agreement may have a provision that the decision by the issuing company to sell all or substantially all of a company's assets and a subsequent distribution to common stockholders triggers redemption of the preferred equity security. In this case, the security would be appropriately classified as part of permanent equity if the preferred stockholders cannot trigger or otherwise require the sale of the assets through representation on the board of directors, or through other rights, because the decision to sell all or substantially all of the issuer's assets and the distribution to common stockholders is solely within the issuer's

control. In other words, if there could not be a "hostile" asset sale whereby all or substantially all of the issuer's assets are sold, and a dividend or other distribution is declared on the issuer's common stock, without the issuer's approval, then classifying the security as part of permanent equity would be appropriate.

11. As another example, a preferred stock agreement may have a provision that provides for redemption of the preferred security if the issuing company is merged with or consolidated into another company, and pursuant to state law, approval of the board of directors is required before any merger or consolidation can occur. In that case, assuming the preferred stockholders cannot control the vote of the board of directors through direct representation or through other rights, the security would be appropriately classified as part of permanent equity because the decision to merge with or consolidate into another company is within the control of the issuer. Again, all of the relevant facts and circumstances must be considered when determining whether the preferred stockholders can control the vote of the board of directors.

12. An equity security may become redeemable upon the disability of the holder. In addition, an equity security may become redeemable upon the death of the holder, at the option of the holder's heir or estate. In this narrow, limited exception in which the redemption upon death (at the option of the holder's heir or estate) or disability will be funded from the proceeds of an insurance policy that is currently in force and which the company has the intent and ability to maintain in force, classifying the security as part of permanent equity would be appropriate. This is a narrow exception that should not be analogized to for other transactions, including circumstances in which an equity security must be redeemed upon the death of the holder.[3]

Measurement

13. In adopting ASR 268 in 1979, the Commission stated that it was not its "intention to deal with the conceptual issue of whether redeemable preferred stock is a liability." Further, the Commission stated that it was not its "intention to alter existing practice or authoritative guidelines relative to accounting for elements of stockholders' equity . . . (for example, the determination of the carrying value of redeemable preferred stock . . .). [ASR 268] is intended to represent only an interim solution until the FASB, in connection with its conceptual framework project, addresses the related conceptual issues."

[3] Pursuant to Statement 150, shares of stock that are required to be redeemed by the issuer upon the death of the holder are classified as a liability, because redemption is required upon an event (that is, death) that is certain to occur. Mandatorily redeemable shares are classified as liabilities under Statement 150 even if an insurance policy would fund the redemption.

14. In May 2003, the FASB issued Statement 150, which addresses how an issuer classifies in its statement of financial position and measures certain financial instruments that have characteristics of both liabilities and equity. [Note: See Subsequent Developments section below.] Statement 150 does not address all of the instruments to which ASR 268 (Rule 5-02.28 of Regulation S-X) and the interpretive guidance in this staff announcement had originally applied. The SEC staff has the following observations about the valuation of redeemable preferred stock that is not within the scope of Statement 150.

15. The SEC staff believes the initial carrying amount of redeemable preferred stock should be its fair value at date of issue. This SEC staff announcement does not change the accounting for derivative instruments or embedded derivatives that are within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (as amended), which must be accounted for in accordance with the provisions of that Statement. If redeemable currently (for example, at the option of the holder), the security should be adjusted to its redemption amount at each balance sheet date. The redemption amount at each balance sheet date should include amounts representing dividends not currently declared or paid but which will be payable under the redemption features or for which ultimate payment is not solely within the control of the registrant (for example, dividends that will be payable out of future earnings). If the security is not redeemable currently (for example, because a contingency has not been met), and it is not probable that the security will become redeemable, subsequent adjustment is not necessary until it is probable that the security will become redeemable. In that case, the SEC staff would expect disclosure of why it is not probable that the security will become redeemable.

16. If it is probable that the security will become redeemable, the staff will not object to either of the following accounting methods:

    1. Accrete changes in the redemption value over the period from the date of issuance (or from the date that it becomes probable that the security will become redeemable, if later) to the earliest redemption date of the security using an appropriate methodology, usually the interest method. Changes in the redemption value are considered to be changes in accounting estimates and accounted for, and disclosed, in accordance with APB Opinion No. 20, *Accounting Changes*.
    2. Recognize changes in the redemption value (for example, market value) immediately as they occur and adjust the carrying value of the security to equal the redemption value at the end of each reporting period. This method would view the end of the reporting period as if it were also the redemption date for the security.

17. <u>The SEC staff will expect consistent application of the accounting method selected, along with appropriate disclosure of the selected policy in the footnotes to the financial statements. Moreover, disclosure of the redemption value of the</u>

security as if it were redeemable is required for registrants that elect to accrete changes in redemption value over the period from the date of issuance to the earliest redemption date.

Earnings Per Share

18. Regardless of the accounting method selected, the resulting increases or decreases in the carrying amount of ~~the~~ a redeemable security other than common stock shall be treated in the same manner as dividends on nonredeemable stock and shall be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital. Increases or decreases in the carrying amount shall reduce or increase income applicable to common stockholders in the calculation of earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends. If charges or credits are material to income, separate disclosure of income applicable to common stockholders on the face of the income statement should be provided.

19. ~~The SEC staff will expect consistent application of the accounting method selected, along with appropriate disclosure of the selected policy in the footnotes to the financial statements. Moreover, disclosure of the redemption value of the security as if it were redeemable is required for registrants that elect to accrete changes in redemption value over the period from the date of issuance to the earliest redemption date.~~ Similarly, regardless of the accounting method selected, the resulting increases or decreases in the carrying amount of redeemable common stock shall be treated in the same manner as dividends on nonredeemable stock and shall be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital. However, increases or decreases in the carrying amount of a redeemable common stock should not affect income applicable to common shareholders. Rather, the SEC staff believes that to the extent that a common shareholder has a contractual right to receive at share redemption (other than upon ordinary liquidation events) an amount that is other than the fair value of such shares, then that common shareholder has, in substance, received a preferential distribution. Under FASB Statement No. 128, *Earnings per Share*, paragraph 60(b), entities with capital structures that include a class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights, should apply the two-class method of calculating earnings per share. Therefore, when a class of common stock is redeemable at other than fair value, increases or decreases in the carrying amount of the redeemable security should be reflected in earnings per share using a method akin to the two-class method.[4] For common

[4] The two-class method of computing earnings per share is addressed in Statement 128 and Issue No. 03-6, "Participating Securities and the Two-Class Method under Statement No. 128."

stock redeemable at fair value, the SEC staff would not expect the use of a method akin to the two-class method, as a redemption at fair value does not amount to a preferential distribution.

Transition

20. When this announcement was made in July 2001, it was to be applied retroactively in the first fiscal quarter ending after December 15, 2001, by restating the financial statements of prior periods in accordance with the provisions of paragraphs 27–30 of Opinion 20.

21. At the September 15, 2005 meeting, the SEC staff also clarified the impact of certain redeemable securities on earnings per share calculations in paragraph 19. The guidance in paragraph 19 should be applied in the first fiscal period beginning after September 15, 2005 (the date of the announcement). Prior period earnings per share amounts presented for comparative purposes should be retroactively adjusted to conform to the guidance.

Subsequent Developments

22. In May 2003, the FASB issued Statement 150, which establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or as an asset in some circumstances) because that financial instrument embodies an obligation of the issuer. For public entities, Statement 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise effective at the beginning of the interim period beginning after June 15, 2003.

23. Statement 150 addresses three types of freestanding financial instruments that embody obligations of the issuer:

- Mandatorily redeemable financial instruments: Financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instruments by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.
- Obligations to repurchase the issuer's equity shares by transferring assets: Financial instruments, other than outstanding equity shares, that at inception embody an obligation to repurchase the issuer's equity shares (or that are indexed to such an obligation) and that require or may require the issuer to settle the obligation by transferring assets. Examples include forward purchase contracts or written put options on the issuer's equity shares that are to be physically settled or net cash settled.
- Certain obligations to issue a variable number of shares: Financial instruments that embody an unconditional obligation, or financial instruments other than outstanding equity shares that embody a conditional obligation, that the issuer

must or may settle by issuing a variable number of its equity shares if, at inception, the monetary value of the obligation is based solely or predominantly on (a) a fixed monetary amount known at inception, (b) variations in something other than the fair value of the issuer's equity shares, or (c) variations inversely related to changes in the fair value of the issuer's equity shares. Examples include a payable settleable with a variable number of the issuer's equity shares, a financial instrument indexed to the S&P 500 and settleable with a variable number of the issuer's equity shares, and a written put option that could be net share settled.

24. Instruments within the scope of Statement 150 should be classified and measured in accordance with that Statement. ASR 268 (Rule 5-02.28 of Regulation S-X) and the interpretive guidance in this staff announcement no longer apply for those instruments after the effective date of Statement 150.

25. At the November 12–13, 2003 meeting, the SEC Observer announced the SEC staff's position relating to the application of Topic D-98 to certain mandatorily redeemable securities for which the relevant portions of Statement 150 were recently deferred in FSP FAS 150-3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150." The SEC Observer clarified that SEC registrants with instruments that qualify for the deferral should refer to Topic D-98 for guidance related to classification and/or measurement, as applicable, for those securities that, for the time being, will not be accounted for in accordance with Statement 150.

26. At the March 17–18, 2004 meeting, the SEC Observer clarified the SEC staff's position relating to the interaction of Topic D-98 and Statement 150 for conditionally redeemable preferred shares. If a company issues preferred shares that are conditionally redeemable, for example, at the holder's option or upon the occurrence of an uncertain event not solely within the company's control, the shares are not within the scope of Statement 150 because there is no unconditional obligation to redeem the shares by transferring assets at a specified or determinable date or upon an event certain to occur. If the uncertain event occurs, the condition is resolved, or the event becomes certain to occur, then the shares become mandatorily redeemable under Statement 150 and would require reclassification to a liability. Paragraph 23 of that Statement requires the issuer to measure that liability initially at fair value and reduce equity by the amount of that initial measure, recognizing no gain or loss. This reclassification of shares to a liability is akin to the redemption of such shares by issuance of debt. Similar to the accounting for the redemption of preferred shares (refer to Topic No. D-42, "The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock"), to the extent that the fair value of the liability differs from the carrying amount of the preferred shares, upon

reclassification that difference should be deducted from or added to net earnings available to common shareholders in the calculation of earnings per share.

27. At the September 15, 2005 meeting, the SEC Observer announced the SEC staff's position on the impact of certain redeemable securities on earnings per share calculations. Paragraph 19 was modified to clarify the SEC staff's position and paragraph 21 was added to address the timing of the application of the position. The SEC Observer also reiterated the SEC staff's positions on several issues and provided additional guidance related to the application of Topic D-98 to share-based payment arrangements with employees. These positions are included in paragraphs 28–30 below.

28. In Staff Accounting Bulletin No. 107, the SEC staff clarified that registrants must evaluate whether the terms of instruments granted in conjunction with share-based payment arrangements with employees that are not classified as liabilities under FASB Statement No. 123 (revised 2004), *Share-Based Payment*, result in the need to present certain amounts outside of permanent equity in accordance with ASR 268 and Topic D-98. The SEC staff expects that this guidance be applied concurrently with the adoption of Statement 123(R). Upon transition, awards previously classified as permanent equity that are now required to be classified outside of permanent equity should be reclassified at the amount required to be presented outside of permanent equity.

29. In SAB 107, the SEC staff clarified that instruments granted in conjunction with share-based payment arrangements with employees that do not by their terms require redemption for cash or other assets (at a fixed or determinable price on a fixed or determinable date, at the option of the holder, or upon the occurrence of an event that is not solely within the control of the issuer) would not be assumed by the staff to require net cash settlement for purposes of applying ASR 268 and Topic D-98 in circumstances in which paragraphs 14–18 of Issue 00-19 would otherwise require the assumption of net cash settlement.

30. Certain employee awards contain provisions for either direct or indirect repurchase of shares issued upon exercise of employee options in order to meet the employer's minimum statutory withholding requirement resulting from the exercise. Statement 123(R) does not require awards with this specific provision, described in paragraph 35, to be classified as liabilities. The SEC staff would not expect SEC registrants to classify such employee awards outside of permanent equity, if the direct or indirect repurchase of shares is done solely to satisfy the employer's minimum statutory tax withholding requirements.

DISCUSSION OF AGENDA TECHNICAL ISSUES

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 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 inventory purchase and sales transactions may be pursuant to a single arrangement or separate 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 purchase and sales transactions with the same counterparty should be viewed as a single exchange 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 20(b) 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 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 (paragraph 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 observed 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).

6. At the June 15–16, 2005 EITF meeting, the Task Force agreed that the scope of this Issue should apply only to purchase and sales of inventory (inventory purchase and sales transactions) with the same counterparty 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 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 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 purchase and sales transactions with the same counterparty should be considered as a single exchange 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.
- Inventory purchase and sales transactions with the same counterparty are entered into simultaneously.
- Inventory purchase and sales transactions were at off-market terms.
- Relative certainty that reciprocal transactions with the same counterparty will occur.

8. The Task Force agreed that none of the above factors taken 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 would be permitted in periods for which financial statements have not been issued.

10. The Task Force asked the FASB 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.

Current EITF Discussion

11. The draft abstract was posted to the FASB website on July 7, 2005, for a 45-day comment period. At the September 15, 2005 EITF meeting, the Task Force considered the comment letters on the draft abstract reflecting the tentative conclusions reached at the March 17 and June 15–16, 2005 EITF meetings. Based on its consideration of the comment letters, the Task Force reached the following conclusions:

a. No further clarification of the scope of this Issue is necessary. However, one Task Force member requested that the FASB staff research whether transactions involving products that are not capable of being held in inventory (for example, electricity) should be subject to guidance similar to that in this Issue and determine whether those transactions should be considered by the EITF Agenda Committee.
b. Examples of the application of the consensus in this Issue should be provided in the final abstract.

12. The Task Force approved as a consensus the tentative conclusions reached at the March 17, 2005 EITF meeting (Issue 2) and the June 15–16, 2005 EITF meeting (Issue 1) as reflected in the draft abstract posted to the FASB website on July 7, 2005. However, some Task Force members suggested that certain additional changes be made to the draft abstract to further clarify some of the indicating factors. The FASB staff agreed to make those changes prior to issuance of the final abstract. (Changes to the draft abstract posted to the FASB website for comment on July 7, 2005, are shown in Appendix 04-13A; additions are underscored and deletions are struck through.)

Transition

13. The Task Force also reached a consensus that this Issue should be applied to new arrangements entered into, or modifications or renewals of existing arrangements, beginning in the first interim or annual reporting period beginning after March 15, 2006.

Board Ratification

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

Status

15. No further EITF discussion is planned.

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 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 to be sold in the same line of business. The inventory purchase and sales 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:

[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.**

Issue 1— The circumstances under which two or more inventory purchase and sales transactions with the same counterparty should be viewed as a single ~~nonmonetary~~ exchange 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 observed~~s~~ that this Issue does not address whether transactions that are reported at fair value qualify for revenue recognition. The FASB staff also observed that guidance in Issue No. 01-2, "Interpretations of APB Opinion No. 29," regarding the extent of boot (that is, net cash exchanged), should also be considered when determining whether the inventory purchase and sales transactions are monetary or nonmonetary in nature.

EITF DISCUSSION

Issue 1—The circumstances under which two or more inventory purchase and sales transactions with the same counterparty should be viewed as a single ~~nonmonetary~~ exchange transaction ~~within the scope of~~subject to Opinion 29.

4. The Task Force reached a consensus on Issue 1 that two or more 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 one~~an~~ inventory transaction is legally contingent upon the performance of another inventory transaction with the same counterparty, the two transactions are deemed to have been entered into ~~are~~ in contemplation of one another and would be ~~should be combined for purposes of applying~~considered a single exchange transaction subject to 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 purchase and sales transactions with the same counterparty should be considered as a single ~~nonmonetary inventory~~exchange transaction ~~within the scope of~~subject to 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 (hereinafter referred to as indicators) may indicate that a purchase transaction and a sales transaction were entered into in contemplation of one another:

- *There is a specific legal right of offset of obligations between counterparties involved in inventory purchase and sales transactions.*
  The ability to offset the payable(s) and receivable(s) related to the separately documented inventory purchase and sales 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. This indicator is more relevant to settlement provisions relating to inventory purchase and sales transactions that are specifically identified (specified legal right of offset) by both counterparties than to inventory transactions that are netted as part of a master netting agreement that encompasses all transactions (inventory and noninventory) between the two counterparties.

- *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 entered into at terms that were off-market ~~terms~~when the arrangement was agreed to between counterparties.*

  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. If that counterparty chooses to deliver its product to the company, the company is obligated to purchase that product. 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 above ~~factors~~ indicators taken individually are determinative nor is the list all-inclusive. Examples of the application of the above indicators to a variety of fact patterns are provided in Exhibit 04-13A.

6. If two or more inventory purchase and sales 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* for the entity transferring the finished goods, as described in paragraph 20(b) of Opinion 29, ~~as amended by Statement 153,~~[2] and, therefore, should be recognized by that~~e~~ entity at fair value if (a) fair value is determinable within reasonable limits and (b) the transaction has commercial substance (paragraph~~s 20 and~~ 21 of Opinion 29~~, as amended by Statement 153~~). 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

~~[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.~~

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.

Transition

9. The Task Force agreed that ~~the consensus in~~ this Issue should be applied to new arrangements entered into, and modifications or renewals of existing arrangements, beginning in the first interim or annual reporting period beginning after March 15, 2006~~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~~this Issue and that still remains in an entity's statement of financial position at the date of initial application of this Issue~~the consensus~~ should not be adjusted for this ~~consensus~~Issue. 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.

Exhibit 04-13A

EXAMPLES OF THE APPLICATION OF THE CONSENSUS ON ISSUE 04-13

The following examples are provided to illustrate the application of the consensus in Issue 04-13. The application of the indicators depends on the relative facts and circumstances and requires significant judgment. The assessment of that judgment in a given fact pattern is based on the assumed facts; accordingly, judgment will vary in differing fact patterns.

1. Sale and purchase of inventory between two oil companies.

   Scenario: Oil Company A produces heavy crude oil (dense, viscous crude oil) in California and has refining operations in other parts of the United States including West Texas. Given its supply-chain management needs, Company A would like to acquire West Texas intermediate crude oil in the most cost-efficient manner.

   As part of its analysis in determining the most cost-efficient approach to acquiring West Texas intermediate crude oil, Company A uses the following available information regarding the current oil needs (demand) and excess oil capacity (supply) of the various oil companies:

Company	Demand/Location	Supply/Location
Company A	West Texas intermediate crude oil/Texas	Heavy crude oil/California
Company B	Heavy crude oil/California	Sweet crude oil/Oklahoma
Company C	Sweet crude oil/Oklahoma	West Texas intermediate crude oil/Texas

   Company A enters into an arrangement to sell Company B a specified quantity of its California production and enters into a separate arrangement at the same time to purchase a specified quantity of Company B's sweet crude oil production in Oklahoma. Also at the same time, Company A enters into an arrangement to sell Company C the sweet crude oil in Oklahoma purchased from Company B, and enters into a separate arrangement at the same time to acquire a specified quantity and quality of West Texas intermediate crude oil from Company C for its West Texas refining operations.

   Company A issues invoices and purchase orders for each transaction and each is gross-cash settled at market prices. Although the quantities differ, there is an insignificant difference in total value of oil being exchanged in each transaction. Company A would not sell its inventory to Company B or Company C without an understanding that the counterparty will perform. Company A considers all crude oil to be the same class of inventory (that is, raw materials) for purposes of financial reporting. Company A does not account for these arrangements as derivatives; therefore, the guidance in Issue No. 03-11, "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not 'Held for Trading Purposes' as Defined in Issue No. 02-3," is not applicable.

Evaluation: Company A's inventory purchase and sales transactions with Company B were entered into in contemplation of one another because the sole purpose of selling inventory was to procure inventory from the same counterparty in the most cost-efficient manner. While it is a matter of judgment as to whether Company A entered into its inventory purchase and sales transactions with Company B in contemplation of one another, certain factors support this assessment. For instance, the transaction to sell inventory was entered into simultaneously with the transaction to purchase inventory. In addition, the sole purpose of selling heavy crude oil inventory is to facilitate the purchase of sweet crude oil inventory. Although the purpose of a transaction is not explicitly identified as an indicator in the consensus guidance, it is nevertheless relevant to the assessment of whether the inventory transactions were entered into in contemplation of one another. While the inventory transactions were not settled on a net basis nor were they entered into at off-market prices, the other indicators, together with the specific facts and circumstances described above, provide persuasive evidence that the transactions were entered into in contemplation of one another. Therefore, although each transaction was separately documented and gross-cash settled at market prices, the inventory transactions should be deemed a single exchange between Company A and Company B for purposes of applying Opinion 29. From the perspective of Company A, an analysis of the inventory purchase and sales transactions between Company A and Company C would result in the same conclusion as the analysis of the transactions between Company A and Company B.

Company A would recognize the single exchange transactions with both Company B and Company C at carryover basis because, from Company A's perspective, the same class of inventory (raw materials for raw materials) was surrendered and received.

2. Sale and purchase of inventory between auto dealers.

Scenario: Dealer A in Suburb X has an excess inventory of cars relative to near term expected demand and does not have enough pickup trucks to meet near term expected demand. Dealer B in Suburb Y has an excess inventory of pickup trucks and not enough cars to meet near term expected demand. Dealer A negotiates an arrangement to sell a specified number of cars to Dealer B and, although not committed to do so, Dealer B may deliver pickup trucks of equivalent value at wholesale prices to Dealer A. Dealer A must purchase pickup trucks from Dealer B if Dealer B chooses to deliver the trucks the following week. Historically, Dealer B has always delivered the trucks to Dealer A under these types of arrangements. At the time Dealer A delivers its cars to Dealer B, Dealer A believes Dealer B will ship the trucks the following week. Each transaction is separately documented and gross-cash settled at wholesale prices on the date of delivery.

Evaluation: Dealer A's inventory sales transaction was entered into in contemplation of a reciprocal inventory purchase transaction from Dealer B because, as a condition of selling inventory to Dealer B, Dealer A must accept delivery of trucks from Dealer B at a later date, if Dealer B chooses to make such a delivery. Consistent with past history, when Dealer A enters into this kind of arrangement with Dealer B, Dealer A fully expects to purchase the trucks. Therefore, the sale of the cars should be considered combined with the purchase of the trucks.

While it is a matter of judgment as to whether Dealer A entered into its inventory sales transaction in contemplation of the inventory purchase transaction, certain factors support this assessment. For instance, a transaction to sell cars to Dealer B was entered into with an anticipated transaction to purchase trucks from Dealer B (if Dealer B chooses to deliver the trucks) simultaneously. Even though the transaction to purchase trucks depended on whether Dealer B chose to deliver, Dealer A believed that there was a high degree of certainty that Dealer B would deliver. In addition, because the inventory pricing is at wholesale, it indicates that these transactions were not on the same terms as transactions with their typical retail customers. While this last factor is not related to a specific indicator in the consensus guidance, it is relevant in assessing the nature of the relationship between Dealer A and Dealer B in the context of the purchase and sales transactions. While Dealer A and Dealer B did not agree to net-settle the inventory transactions, the expectation of a reciprocal purchase transaction from Dealer B in the context of the relationship between Dealer A and Dealer B indicates that the sale transaction by Dealer A to Dealer B was entered into in contemplation of the purchase transaction from Dealer B. Therefore, although each transaction was separately documented and gross-cash settled, these inventory transactions should be deemed a single exchange for purposes of applying Opinion 29.

When evaluating the inventory transactions as a single nonmonetary exchange, Dealer A would recognize the transactions at carryover basis because the same class of inventory is being exchanged (finished goods exchanged for finished goods).

3. Sale and purchase of inventory between two manufacturers.

Scenario: Multinational Manufacturer A has a longstanding business relationship with multinational Manufacturer B, whereby each manufacturer will buy and sell inventory from the other on an as-needed basis at market prices. Manufacturer A sells materials to Manufacturer B based on a purchase order from Manufacturer B. Two days later, Manufacturer B sells materials to Manufacturer A based on a separate purchase order from Manufacturer A. Neither transaction was predicated on the occurrence of the other transaction occurring through either an implied arrangement or a contractual arrangement, and, historically, Manufacturer A has sold twice as much in value to Manufacturer B as Manufacturer B has sold to Manufacturer A. Both of these inventory transactions are gross-cash settled at market prices.

Evaluation: Manufacturer A's inventory purchase and sales transactions were not entered into in contemplation of one another.

This assessment is supported by reciprocal inventory purchase and sales transactions not being negotiated between the two counterparties at the same time. In addition, there is no correlation between the value of goods delivered to Manufacturer B to the value of goods received from Manufacturer B. Although this last factor is not explicitly identified in the consensus in this Issue, it further strengthens the assessment that the inventory transactions were not entered into in contemplation of one another. Consequently, the inventory purchase and sales transactions would not be deemed a single exchange for purposes of applying Opinion 29 and would be considered separate monetary transactions subject to the guidance in other relevant Generally Accepted Accounting Principles.

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; September 15, 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.

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 at a future EITF meeting.

Current EITF Discussion
7. At the September 15, 2005 EITF meeting, the Task Force discussed accounting for the conversion of an instrument that becomes convertible upon the issuer's exercise of a call option but was unable to reach a consensus. Task Force members were divided between treating all such conversions as extinguishments and treating only conversions of instruments that did not otherwise contain a substantive conversion contingency as extinguishments. Consequently, the Task Force no longer supported its previous tentative conclusion and asked the FASB staff to

research the operationality of an alternative view that would result in either debt conversion accounting or debt extinguishment accounting depending on whether the instrument, at issuance, contains a substantive conversion feature that is outside the control of the issuer.

Status

8. Further discussion is expected at a future meeting.

Issue No. 05-7

Title: Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues

Date Discussed: September 15, 2005

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

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

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

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

Issue

1. In the past, when an issuer modified previously issued convertible debt, there were differing views on whether to include the change in the fair value of an embedded conversion option in the EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," analysis to determine whether a substantial modification had occurred. However, at the December 2004 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff discussed the accounting for the modification of conversion options in convertible debt instruments as it relates to Issue 96-19 and stated, in part:

> When an issuer modifies a convertible security, the issuer must compare the fair value of the conversion option immediately following such modification with its fair value immediately prior to the modification. In using the term fair value, I am referring to both the intrinsic and time value components of the conversion option. To the extent that a difference is identified, that difference should be included in any EITF Issue 96-19 analysis in the same way as one would include a current period cash flow. An example of a current period cash flow would be any fees exchanged between the debtor and the creditor, the treatment of which is explicitly addressed in the provisions of EITF 96-19. [Footnote reference omitted.]

2. While the speech provided guidance for SEC registrants on determining whether the modification results in an extinguishment of the debt instrument pursuant to the guidance in Issue 96-19, additional questions have been raised regarding the accounting for those types of modifications as well as whether the Issue 96-19 analysis applies to non-SEC registrants.

3. The issues are:

Issue 1—Whether the change in the fair value of an embedded conversion option that results from a modification of a convertible debt instruments should be included in the analysis of whether there has been a substantial change in the terms of the debt instrument to determine if a debt extinguishment has occurred pursuant to Issue 96-19

Issue 2—In modifications that do not result in a debt extinguishment pursuant to Issue 96-19, whether the modification to a convertible debt instrument that changes the fair value of an embedded conversion option affects subsequent recognition of interest expense for the associated debt instrument

Issue 3—In modifications that do not result in a debt extinguishment pursuant to Issue 96-19, whether an issuer should recognize a beneficial conversion feature or reassess an existing beneficial conversion feature if upon modification of a convertible debt instrument, the embedded conversion option is in-the-money and the intrinsic value of the embedded conversion option has increased.

Scope

4. The scope of this Issue applies to convertible debt instruments that are accounted for under Opinion 14 and related interpretations. Issues 2 and 3 relate to modifications that are not accounted for as extinguishments under Issue 96-19.

Current EITF Discussion

5. At the September 15, 2005 EITF meeting, the Task Force reached a consensus on Issue 1 that an entity should include, upon the modification of a convertible debt instrument, the change in fair value of the related embedded conversion option in the analysis to determine whether a debt instrument has been extinguished pursuant to Issue 96-19. The change in the fair value of an embedded conversion option should be calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification and it should be included in the Issue 96-19 analysis because there is a direct correlation between the value of an embedded conversion option and the yields demanded on a convertible debt instrument. Because the determination of whether an extinguishment or modification has occurred under Issue 96-19 focuses solely on a differential *cash flow* analysis, the Task Force agreed to amend Issue 96-19 to include non-cash changes to the conversion terms under this consensus. (Changes to Issue 96-19 are shown in Appendix 05-7B; additions are underscored and deletions are struck through.)

6. The Task Force reached a consensus on Issue 2 that the modification of a convertible debt instrument should affect subsequent recognition of interest expense for the associated debt instrument for changes in the fair value of the embedded conversion option. The change in the fair value of an embedded conversion option should be calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification. The Task Force observed that the value exchanged by the holder for the modification of the conversion option should be recognized as a discount (or premium) with a corresponding increase (or decrease) in additional paid-in capital. In reaching that conclusion, the Task Force discussed whether this consensus is inconsistent with Opinion 14 (which generally does not permit separate recognition of an embedded conversion option). The Task Force did not believe the consensus on Issue 2 was inconsistent with Opinion 14 because Opinion 14 only pertains to the accounting at issuance for convertible debt instruments and does not address the accounting for modifications to convertible debt instruments. In addition, the Task Force observed that the consensus reached in Issue 2 is consistent with the guidance in Issue 96-19 on accounting for

fees paid by the debtor to the creditor or received by the debtor from the creditor as part of a modification that does not result in a debt extinguishment under Issue 96-19.

7. The Task Force reached a consensus on Issue 3 that the issuer should not recognize a beneficial conversion feature or reassess an existing beneficial conversion feature upon modification of a convertible debt instrument. The Task Force concluded that the only value associated with the modification of an embedded conversion option (feature) that should be accounted for is the change in the *fair* value of the embedded conversion option discussed under Issue 2.

Transition

8. The Task Force also reached a consensus that this Issue should be applied to future modifications of debt instruments beginning in the first interim or annual reporting period beginning after December 15, 2005. Early application of this guidance is permitted in periods for which financial statements have not yet been issued. The disclosures required by Statement 154 should be made excluding those disclosures that require the effects of retroactive application.

9. The SEC Observer noted that the SEC staff has previously reached a conclusion consistent with the consensus in Issue 1.[1] In considering the Issue previously, the SEC staff has taken exception to excluding the change in fair value of an embedded conversion option from the Issue 96-19 analysis in cases in which the changes to the convertible debt appeared to have been structured around Issue 96-19 in an effort to avoid extinguishment accounting. As such, SEC registrants should expect that the SEC staff will continue to challenge modification accounting in similar circumstances, even if such transactions occurred prior to the effective date of this consensus.

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.

[1] See speech by Robert J. Comerford, December 6, 2004, available at www.sec.gov.

Appendix 05-7A

EITF ABSTRACTS (DRAFT[1])

Issue No. 05-7

Title: Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues

Date Discussed: September 15, 2005

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

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

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

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

ISSUE

1. In the past, when an issuer modified previously issued convertible debt, there were differing views on whether to include the change in the fair value of an embedded conversion option in the Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," analysis to determine whether a substantial modification had occurred. However, at the December 2004 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff discussed the accounting for the modification of conversion options in convertible debt instruments as it relates to Issue 96-19 and stated, in part:

> When an issuer modifies a convertible security, the issuer must compare the fair value of the conversion option immediately following such modification with its fair value immediately prior to the modification. In using the term fair value, I am referring to both the intrinsic and time value components of the conversion option. To the extent that a difference is identified, that difference should be included in any EITF Issue 96-19 analysis in the same way as one would include a current period cash flow. An example of a current period cash flow would be any fees exchanged between the debtor and the creditor, the treatment of which is explicitly addressed in the provisions of EITF 96-19. [Footnote reference omitted.]

[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. While the speech provided guidance for SEC registrants on determining whether the modification results in an extinguishment of the debt instrument pursuant to the guidance in Issue 96-19, additional questions have been raised regarding the accounting for those types of modifications as well as whether the Issue 96-19 analysis applies to non-SEC registrants.

3. The issues are:

Issue 1—Whether the change in the fair value of an embedded conversion option that results from a modification of a convertible debt instrument should be included in the analysis of whether there has been a substantial change in the terms of a debt instrument to determine if a debt extinguishment has occurred pursuant to Issue 96-19

Issue 2—In modifications that do not result in a debt extinguishment pursuant to Issue 96-19, whether the modification to a convertible debt instrument that changes the fair value of an embedded conversion option affects subsequent recognition of interest expense for the associated debt instrument

Issue 3—In modifications that do not result in a debt extinguishment pursuant to Issue 96-19, whether an issuer should recognize a beneficial conversion feature or reassess an existing beneficial conversion feature if upon modification of a convertible debt instrument, the embedded conversion option is in-the-money and the intrinsic value of the embedded conversion option has increased.

Scope

4. The scope of this Issue applies to convertible debt instruments that are accounted for under Opinion 14 and related interpretations. Issues 2 and 3 relate to modifications that are not accounted for as extinguishments under Issue 96-19.

EITF DISCUSSION

5. The Task Force reached a consensus on Issue 1 that an entity should include, upon the modification of a convertible debt instrument, the change in fair value of the related embedded conversion option in the analysis to determine whether a debt instrument has been extinguished pursuant to Issue 96-19. The change in the fair value of an embedded conversion option should be calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification and it should be included in the Issue 96-19 analysis because there is a direct correlation between the value of an embedded conversion option and the yields demanded on a convertible debt instrument. Because the determination of whether an extinguishment or modification has occurred under Issue 96-19 focuses solely on a differential *cash flow* analysis, the Task Force agreed to amend Issue 96-19 to include non-cash changes to the conversion terms under this consensus. (Changes to Issue 96-19 are shown in Appendix 05-7B; additions are underscored and deletions are struck through.)

6. The Task Force reached a consensus on Issue 2 that the modification of a convertible debt instrument should affect subsequent recognition of interest expense for the associated debt instrument for changes in the fair value of the embedded conversion option. The change in the

fair value of an embedded conversion option should be calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification. The Task Force observed that the value exchanged by the holder for the modification of the conversion option should be recognized as a discount (or premium) with a corresponding increase (or decrease) in additional paid-in capital. In reaching that conclusion, the Task Force discussed whether this consensus is inconsistent with Opinion 14 (which generally does not permit separate recognition of an embedded conversion option). The Task Force did not believe the consensus on Issue 2 was inconsistent with Opinion 14 because Opinion 14 only pertains to the accounting at issuance for convertible debt instruments and does not address the accounting for modifications to convertible debt instruments. In addition, the Task Force observed that the consensus reached on Issue 2 is consistent with the guidance in Issue 96-19 on accounting for fees paid by the debtor to the creditor or received by the debtor from the creditor as part of a modification that does not result in a debt extinguishment under Issue 96-19.

7. The Task Force reached a consensus on Issue 3 that the issuer should not recognize a beneficial conversion feature or reassess an existing beneficial conversion feature upon modification of a convertible debt instrument. The Task Force concluded that the only value associated with the modification of an embedded conversion option (feature) that should be accounted for is the change in the fair value of the embedded conversion option discussed under Issue 2.

Transition

8. The Task Force also reached a consensus that this Issue should be applied to future modifications of debt instruments beginning in the first interim or annual reporting period beginning after December 15, 2005. Early application of this guidance is permitted in periods for which financial statements have not yet been issued. The disclosures required by Statement 154 should be made excluding those disclosures that require the effects of retroactive application.

9. The SEC Observer noted that the SEC staff has previously reached a conclusion consistent with the consensus in Issue 1.[2] In considering the Issue previously, the SEC staff has taken exception to excluding the change in fair value of an embedded conversion option from the Issue 96-19 analysis in cases in which the changes to the convertible debt appeared to have been structured around Issue 96-19 in an effort to avoid extinguishment accounting. As such, SEC registrants should expect that the SEC staff will continue to challenge modification accounting in similar circumstances, even if such transactions occurred prior to the effective date of this consensus.

Board Ratification

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

[2] See speech by Robert J. Comerford, December 6, 2004, available at www.sec.gov.

STATUS

11. No further EITF discussion is planned.

Appendix 05-7B

EITF ABSTRACTS (DRAFT[1])

Issue No. 96-19

Title: Debtor's Accounting for a Modification or Exchange of Debt Instruments

Dates Discussed: September 18-19, 1996; November 14, 1996; January 23, 1997; March 13, 1997; May 21-22, 1997; July 23-24, 1997; July 23, 1998; September 15, 2005

References: FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*

FASB Statement No 76, *Extinguishment of Debt*

FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*

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

APB Opinion No. 30, *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*

SEC Staff Accounting Bulletin No. 94, *Recognition of a Gain or Loss on Early Extinguishment of Debt*

ISSUE

Issue No. 86-18, "Debtor's Accounting for a Modification of Debt Terms," addresses circumstances under which existing debt should be considered extinguished, resulting in recognition by the debtor of an extraordinary gain or loss. [Note: See STATUS section.] In that Issue, the Task Force reached a consensus that an exchange of a new noncallable debt instrument for an older callable debt instrument should be accounted for as an extinguishment by the debtor. Many Task Force members agreed that substantive modifications of debt (that is, modifications to principal, interest rate, maturity, or call provisions) should be accounted for as the extinguishment of that debt and the creation of new debt, although no consensus was reached on that issue. Other Task Force members said that extinguishment accounting should be applied only to those debt instruments meeting the conditions for extinguishment under Statement 76.

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[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.

Statement 125, which superseded Statement 76 on January 1, 1997, limits derecognition of a liability to extinguishments. It limits extinguishments to situations in which the debtor pays the creditor and is relieved of its obligation or is legally released as the primary obligor either judicially or by the creditor.

The issues are:

1. How a debtor should account for an exchange of debt instruments with substantially different terms
2. How a debtor should account for a substantial modification in the terms of an existing debt agreement (other than a troubled debt restructuring)
3. If a gain or loss is recognized from an exchange or modification, whether the gain or loss should be classified as extraordinary.

EITF DISCUSSION

The Task Force reached a consensus that an exchange of debt instruments with substantially different terms is a debt extinguishment and should be accounted for in accordance with paragraph 16 of Statement 125. The Task Force observed that a debtor could achieve the same economic effect by making a substantial modification of terms of an existing debt instrument. Accordingly, the Task Force reached a consensus that a substantial modification of terms should be accounted for like, and reported in the same manner as, an extinguishment.

The Task Force also reached the following consensuses regarding (1) when an exchange or modification is considered *substantial,* (2) how to account for fees paid or received by a debtor and costs incurred by a debtor with third parties as part of an exchange or modification, and (3) the impact of the consensuses reached in this Issue on other related EITF Issues.

From the debtor's perspective, an exchange of debt instruments between or a modification of a debt instrument by a debtor and a creditor in a nontroubled debt situation is deemed to have been accomplished with debt instruments that are *substantially different* if the present value of the cash flows (including changes in the fair value of an embedded conversion option[2] upon modification of a convertible debt instrument) under the terms of the new debt instrument is at least *10 percent* different from the present value of the remaining cash flows under the terms of the original instrument.

Cash flows can be affected by changes in principal amounts, interest rates, or maturity. They can also be affected by fees exchanged between the debtor and creditor to effect changes in:

- Recourse or nonrecourse features
- Priority of the obligation
- Collateralized (including changes in collateral) or noncollateralized features

[2] The change in the fair value of an embedded conversion option is calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification. [Note: See STATUS section.]

- Debt covenants and/or waivers
- The guarantor (or elimination of the guarantor)
- Option features.

If the terms of a debt instrument are changed or modified in any of the ways described above and the cash flow effect (including changes in the fair value of an embedded conversion option) on a present value basis is less than 10 percent, the debt instruments are *not* considered to be *substantially different.*

The following guidance is to be used to calculate the present value of the cash flows for purposes of applying the 10 percent test.

1. The cash flows of the new debt instrument include all cash flows specified by the terms of the new debt instrument plus any amounts paid by the debtor to the creditor less any amounts received by the debtor from the creditor as part of the exchange or modification.
2. If the original debt instrument and/or the new debt instrument has a floating interest rate, then the variable rate in effect at the date of the exchange or modification is to be used to calculate the cash flows of the variable-rate instrument.
3. If either the new debt instrument or the original debt instrument is callable or puttable, then separate cash flow analyses are to be performed assuming exercise and nonexercise of the call or put. The cash flow assumptions that generate the smaller change would be the basis for determining whether the 10 percent threshold is met.
4. If the debt instruments contain contingent payment terms or unusual interest rate terms, judgment should be used to determine the appropriate cash flows.
5. If the debt instrument contains an embedded conversion option, the change in the fair value of the embedded conversion option that results from a modification of the debt instrument, should be included in a manner that is similar to the manner in which a current period cash flow would be included. [Note: See STATUS section.]

~~5~~6. The discount rate to be used to calculate the present value of the cash flows is the effective interest rate, for accounting purposes, of the original debt instrument.

~~6~~7. If within a year of the current transaction the debt has been exchanged or modified without being deemed to be substantially different, then the debt terms that existed a year ago should be used to determine whether the current exchange or modification is substantially different.

If it is determined that the original and new debt instruments are *substantially different,* then the calculation of the cash flows related to the new debt instrument at the effective interest rate of the original debt instrument is *not* used to determine the initial amount recorded for the new debt instrument or to determine the debt extinguishment gain or loss to be recognized. The new debt instrument should be initially recorded at fair value and that amount should be used to determine the debt extinguishment gain or loss to be recognized and the effective rate of the new instrument.

If it is determined that the original and new debt instruments are *not* substantially different, then a new effective interest rate is to be determined based on the carrying amount of the original debt instrument and the revised cash flows including any change in the fair value of an embedded conversion option.

Fees paid by the debtor to the creditor or received by the debtor from the creditor (fees may be received by the debtor from the creditor to cancel a call option held by the debtor or to extend a no-call period) as part of the exchange or modification are to be accounted for as follows:

- If the exchange or modification is to be accounted for in the same manner as a debt extinguishment [Note: See STATUS section.] and the new debt instrument is initially recorded at fair value, then the fees paid or received are to be associated with the extinguishment of the old debt instrument and included in determining the debt extinguishment gain or loss to be recognized.
- If the exchange or modification is not to be accounted for in the same manner as a debt extinguishment, then the fees are to be associated with the replacement or modified debt instrument and, along with any existing unamortized premium or discount, amortized as an adjustment of interest expense over the remaining term of the replacement or modified debt instrument using the interest method.

Costs incurred with third parties directly related to the exchange or modification (such as legal fees) are to be accounted for as follows:

- If the exchange or modification is to be accounted for in the same manner as a debt extinguishment [Note: See STATUS section.] and the new debt instrument is initially recorded at fair value, then the costs are to be associated with the new debt instrument and amortized over the term of the new debt instrument using the interest method in a manner similar to debt issue costs.
- If the exchange or modification is not to be accounted for in the same manner as a debt extinguishment, then the costs should be expensed as incurred.

The consensus in Issue No. 95-15, "Recognition of Gain or Loss When a Binding Contract Requires a Debt Extinguishment to Occur at a Future Date for a Specified Amount," is superseded by the consensus in this Issue. The transaction described in Issue 95-15 deals with when a debtor enters into a binding contract with a holder of its debt obligation to redeem the debt security at a future date for a specified amount greater than (or less than) the debtor's carrying amount of the debt for financial reporting purposes. The future date of the exchange specified in the contract will occur within one year of the date that the contract becomes binding to the parties. The debtor's accounting for this transaction is to be accounted for based on the consensus in this Issue.

The guidance in Issue 86-18 for the transaction described below is not affected by the consensus reached in this Issue. In the context of its deliberations on Issue 86-18, the Task Force discussed a specific transaction in which a borrower, instead of acquiring debt securities directly, loans funds to a third party, who in turn acquires the borrower's original debt securities. The borrower and third party agree that they may settle their respective receivables and obligations by right of setoff as payments become due, contingent upon the third party's continued retention of the borrower's original debt. The Task Force reached a consensus in Issue 86-18 that the borrower should not account for the original debt securities as extinguished and that those securities should not be offset against the receivable from the third party in the borrower's financial statements.

Implementation Guidelines

The Task Force reached a consensus that:

1. The exchange of cash by the debtor or the debtor's agent to acquire or settle debt is an extinguishment of debt under paragraph 16 of Statement 125. Therefore, such transactions involving the exchange of cash between a debtor and a creditor or creditors are not covered by the scope of this Issue. However, transactions involving contemporaneous exchanges of cash between the same debtor and creditor in connection with the issuance of a new debt obligation and satisfaction of an existing debt obligation by the debtor would only be accounted for as debt extinguishments if the debt instruments have substantially different terms, as defined in this Issue.
2. In transactions involving a third-party intermediary acting as agent on behalf of a debtor, the actions of the intermediary should be viewed as those of the debtor in order to determine whether there has been an exchange of debt instruments or a modification of terms between a debtor and a creditor. Stated another way, when a third-party intermediary acts as agent, the analysis should "look through" the intermediary.
3. In transactions involving a third-party intermediary acting as principal, the intermediary should be viewed as a third-party creditor similar to any other creditor in order to determine whether there has been an exchange of debt instruments or a modification of terms between a debtor and a creditor. Stated another way, when a third-party intermediary acts as principal, the analysis should not "look through" the intermediary.
4. Transactions among debt holders do not result in a modification of the original debt's terms or an exchange of debt instruments between the debtor and the debt holders and do not impact the accounting by the debtor.
5. Transactions between a debtor and a third-party creditor should be analyzed based on the guidance in paragraph 16 of Statement 125 and the consensus in this Issue to determine whether gain or loss recognition is appropriate. Transactions entered into between a debtor or a debtor's agent and a third party that is not the creditor are not included in the scope of this Issue.

The Task Force noted that application of those guidelines may require determination of whether a third-party intermediary is an agent or a principal and that consideration of legal definitions may be helpful in making that determination. The Task Force noted that, generally, an agent acts for and on behalf of another party. Therefore, a third-party intermediary is an agent of a debtor if it acts on behalf of the debtor. In addition, the Task Force noted that an evaluation of the facts and circumstances surrounding the involvement of the third-party intermediary should be performed. The Task Force observed that the following indicators should be considered in that evaluation:

1. If the intermediary's role is restricted to placing or reacquiring debt for the debtor without placing its own funds at risk, that would indicate that the intermediary is an agent. For example, that may be the case if the intermediary's own funds are committed and those funds are not truly at risk because the intermediary is made whole by the debtor (and

therefore is indemnified against loss by the debtor). If the intermediary places and reacquires debt for the debtor by committing its funds and is subject to the risk of loss of those funds, that would indicate that the intermediary is acting as principal.

2. In an arrangement where an intermediary places notes issued by the debtor, if the placement is done under a best-efforts agreement, that would indicate that the intermediary is acting as agent. Under a best-efforts agreement, an agent agrees to buy only those securities that it is able to sell to others; if the agent is unable to remarket the debt, the issuer is obligated to pay off the debt. The intermediary may be acting as principal if the placement is done on a firmly committed basis, which requires the intermediary to hold any debt that it is unable to sell to others.
3. If the debtor directs the intermediary and the intermediary cannot independently initiate an exchange or modification of the debt instrument, that would indicate that the intermediary is an agent. The intermediary may be a principal if it acquires debt from or exchanges debt with another debt holder in the market and is subject to loss as a result of the transaction.
4. If the only compensation derived by an intermediary from its arrangement with the debtor is limited to a preestablished fee, that would indicate that the intermediary is an agent. If the intermediary derives gains based on the value of the security issued by the debtor, that would indicate that the intermediary is a principal.

The Task Force reached a consensus that transactions involving the modification or exchange of debt instruments can only result in gain or loss recognition by the debtor if the conditions for extinguishment of debt described in paragraph 16 of Statement 125 are satisfied or if the consensus in this Issue requires that accounting. Accordingly, the guidance in Issue No. 87-20, "Offsetting Certificates of Deposit against High-Coupon Debt," related to loss recognition is superseded by the consensus in this Issue. The general principles outlined above would apply to the transaction described in Issue 87-20.

The examples in Exhibit 96-19A illustrate the application of the above implementation guidelines.

STATUS

Statement 140 was issued in September 2000 and superseded Statement 125. Statement 140 does not change the guidance dealing with accounting for extinguishments of liabilities.

Statement 145, issued in April 2002, supersedes Statement 4. Statement 4 required that all gains and losses from extinguishment of debt be classified as extraordinary items. Statement 145 removes the extraordinary item classification requirement but does not preclude gains and losses from extinguishment of debt that meet the criteria in Opinion 30 from being classified as extraordinary items.

Issue No. 05-7, "Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues," which was discussed at the September 15, 2005 meeting, amends this Issue to include the change in the fair value of an embedded conversion option resulting from the modification of a convertible debt instrument in the analysis of whether there has been a substantial change in the terms of a convertible debt instrument to determine if a debt extinguishment has occurred. In addition, Issue 05-7 requires the change in the fair value of the embedded conversion option that results from a modification of the convertible debt instrument (that does not result in an extinguishment), to be accounted for as an additional debt discount or premium (similar to other fees paid to creditors) resulting in an effect on the subsequent recognition of interest expense for the associated debt instrument. At its meeting on September 28, 2005, the Board ratified this amendment.

No further EITF discussion is planned.

Issue No. 05-8

Title: Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature

Date Discussed: September 15, 2005

References: FASB Statement No. 109, *Accounting for Income Taxes*

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

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

International Accounting Standard No. 12, *Income Taxes*

Introduction

1. A company may issue a convertible debt security with a nondetachable conversion feature. The nondetachable conversion feature in a convertible debt security is not accounted for separately under Opinion 14. However, when a company issues a convertible debt security with a nondetachable conversion feature that is "in-the-money," EITF Issue No. 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," requires that conversion feature to be accounted for separately. This kind of conversion feature is defined as a beneficial conversion feature and is recognized and measured separately by allocating to additional paid-in capital a portion of the proceeds equal to the intrinsic value of the conversion feature. That intrinsic value is calculated at the commitment date[1] as the difference between the conversion price and the fair value of the common stock or other securities into which the security is convertible, multiplied by the number of shares into which the security is convertible. The convertible security is recorded at par (assuming no discount or premium associated with interest rates at issuance), and a discount is recognized for the amount that is allocated to additional paid-in capital. The debt discount is to be accreted from the date of issuance to the stated redemption date of the convertible instrument or through the earliest conversion date if the instrument does not have a stated redemption date as discussed in Issue 00-

[1] The commitment date is defined in Issue 4 of Issue 00-27 as follows:

> An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:
>
> a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield.
>
> b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment.

27. In contrast, the U.S. Federal Income Tax Code, for example, includes the entire amount of proceeds received at issuance of the debt as the tax basis of the convertible debt security.

Issues

1. The issues are:

Issue 1— Whether the issuance of convertible debt with a beneficial conversion feature results in a basis difference for purposes of applying Statement 109

Issue 2— If the issuance of convertible debt with a beneficial conversion feature results in a basis difference, whether that basis difference is a temporary difference under Statement 109

Issue 3— If the issuance of convertible debt with a beneficial conversion feature results in a temporary difference under Statement 109, whether recognition of the deferred tax liability for the temporary difference of the convertible debt should be recorded as an adjustment to additional paid-in capital or through the recognition of a deferred charge by analogy to the accounting model in Example 4 of EITF Issue No. 98-11, "Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations."

Current EITF Discussion

3. At the September 15, 2005 EITF meeting, the Task Force reached a consensus on Issue 1 that the issuance of convertible debt with a beneficial conversion feature results in a basis difference for purposes of applying Statement 109. The Task Force observed that the recognition of a beneficial conversion feature effectively creates two separate instruments—a debt instrument and an equity instrument—for financial statement purposes while it is accounted for as a debt instrument, for example, under the U.S. Federal Income Tax Code. Consequently, the reported amount in the financial statements (book basis) of the debt instrument is different from the tax basis of the debt instrument.

4. The Task Force reached a consensus on Issue 2 that the basis difference that results from the issuance of convertible debt with a beneficial conversion feature is a temporary difference for purposes of applying Statement 109. The Task Force noted that the definition of a temporary difference in Statement 109 supports the conclusion that the basis difference in the debt security is temporary because that difference will result in a taxable amount "when the reported amount of the liability is recovered or settled" (emphasis added). That is, the liability is presumed to be settled at its current carrying amount (reported amount).

5. The Task Force reached a consensus on Issue 3 that the recognition of deferred taxes for the temporary difference of the convertible debt with a beneficial conversion feature should be recorded as an adjustment to additional paid-in capital. The Task Force observed that because the beneficial conversion feature (an allocation to additional paid-in capital) created the basis difference in the debt instrument, the provisions of paragraph 36(c) of Statement 109 apply and

therefore the establishment of the deferred tax liability for the basis difference should result in an adjustment to the "related components of shareholders' equity."

Transition

6. The Task Force reached a consensus that this Issue should be applied to financial statements beginning in the first interim or annual reporting period beginning after December 15, 2005. This Issue should be applied by retrospective application pursuant to Statement 154 to all instruments with a beneficial conversion feature accounted for under Issue 00-27. Therefore, this Issue would also be applicable to debt instruments that were converted (or extinguished) in prior periods but are still presented in the financial statements. Early application is permitted in periods for which financial statements have not been issued.

Board Ratification

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

Status

8. No further EITF discussion is planned.

Appendix 05-8A

EITF ABSTRACTS (DRAFT[1])

Issue No. 05-8

Title: Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature

Date Discussed: September 15, 2005

References: FASB Statement No. 109, *Accounting for Income Taxes*

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

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

International Accounting Standard No. 12, *Income Taxes*

ISSUE

1. A company may issue a convertible debt security with a nondetachable conversion feature. The nondetachable conversion feature in a convertible debt security is not accounted for separately under Opinion 14. However, when a company issues a convertible debt security with a nondetachable conversion feature that is "in-the-money," Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," requires that conversion feature to be accounted for separately. This kind of conversion feature is defined as a beneficial conversion feature and is recognized and measured separately by allocating to additional paid-in capital a portion of the proceeds equal to the intrinsic value of the conversion feature. That intrinsic value is calculated at the commitment date[2] as the difference between the conversion price and the fair value of the common stock or other securities into which the security is convertible, multiplied by the number of shares into which the security is convertible. The convertible security is recorded at par (assuming no discount or premium associated with interest rates at issuance), and a discount is recognized for the amount that is allocated to additional paid-in capital. The debt discount is to be accreted from the date of issuance to the stated redemption date of the convertible instrument or through the earliest conversion date if the instrument does not have a stated redemption date as discussed in Issue 00-27. In contrast, the U.S. Federal Income Tax Code, for example, includes the entire amount of proceeds received at issuance of the debt as the tax basis of the convertible debt security.

2. The issues are:

[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] The commitment date is defined in Issue 4 of Issue 00-27.

Issue 1— Whether the issuance of convertible debt with a beneficial conversion feature results in a basis difference for purposes of applying Statement 109

Issue 2— If the issuance of convertible debt with a beneficial conversion feature results in a basis difference, whether that basis difference is a temporary difference under Statement 109

Issue 3— If the issuance of convertible debt with a beneficial conversion feature results in a temporary difference under Statement 109, whether recognition of the deferred tax liability for the temporary difference of the convertible debt should be recorded as an adjustment to additional paid-in capital or through the recording of a deferred charge by analogy to the accounting model in Example 4 of Issue No. 98-11, "Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations."

EITF DISCUSSION

3. The Task Force reached a consensus on Issue 1 that the issuance of convertible debt with a beneficial conversion feature results in a basis difference for purposes of applying Statement 109. The Task Force observed that the recognition of a beneficial conversion feature effectively creates two separate instruments—a debt instrument and an equity instrument—for financial statement purposes while it is accounted for as a debt instrument, for example, under the U.S. Federal Income Tax Code. Consequently, the reported amount in the financial statements (book basis) of the debt instrument is different from the tax basis of the debt instrument.

4. The Task Force reached a consensus on Issue 2 that the basis difference that results from the issuance of convertible debt with a beneficial conversion feature is a temporary difference for purposes of applying Statement 109. The Task Force noted that the definition of a temporary difference in Statement 109 supports the conclusion that the basis difference in the debt security is temporary because that difference will result in a taxable amount "when the <u>reported amount</u> of the liability is recovered or settled" (emphasis added). That is, the liability is presumed to be settled at its current carrying amount (reported amount).

5. The Task Force reached a consensus on Issue 3 that the recognition of deferred taxes for the temporary difference of the convertible debt with a beneficial conversion feature should be recorded as an adjustment to additional paid-in capital. The Task Force observed that because the beneficial conversion feature (an allocation to additional paid-in capital) created the basis difference in the debt instrument, the provisions of paragraph 36(c) of Statement 109 apply and therefore the establishment of the deferred tax liability for the basis difference should result in an adjustment to the "related components of shareholders' equity."

Transition

6. The Task Force reached a consensus that this Issue should be applied to financial statements beginning in the first interim or annual reporting period beginning after December 15, 2005. This Issue should be applied by retrospective application pursuant to Statement 154 to all instruments with a beneficial conversion feature accounted for under Issue 00-27. Therefore,

this Issue would also be applicable to debt instruments that were converted (or extinguished) in prior periods but are still presented in the financial statements. Early application is permitted in periods for which financial statements have not been issued

Board Ratification

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

STATUS

8. 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 November 10, 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
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	11/05	Oakley/ Sarno	The FASB staff will prepare an Issue Summary for the November 2005 meeting.	November 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	NA	Sarno	Pending further progress on Phase II of the Board's share-based payments project.	NA
	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.						

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**
00-27	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
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) 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	Not scheduled	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 a future meeting.	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**
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	N/A	Thuener/ Jacobs/ Richards	Pending further progress on a DIG Issue for determining whether a registration rights agreement is a derivative	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