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FINANCIAL ACCOUNTING STANDARDS BOARD
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March 31, 2008

TO: MEMBERS OF THE FASB EMERGING ISSUES TASK FORCE

Included are the final minutes of the March 12, 2008 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 March 27 Fatal Flaw draft. After your review, please discard the confidential marked version of the minutes.

November Meeting
The next EITF meeting will be held on **June 11-12, 2008,** at the FASB offices in Norwalk, Connecticut. Please plan for the meeting to begin on Wednesday, June 11, at 1:00 p.m. and conclude no later than 5:00 p.m. On Thursday, June 12, the meeting will begin at 8:00 a.m. and conclude no later than 4:00 p.m. The meeting times are tentative and may change. Coffee will be available and lunch will be provided. On Wednesday, June 11, the FASB will host a dinner at a location to be announced later.

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

Draft minutes available	**June 17, 2008**
Final minutes available	**July 1, 2008**

Please call me at 203.956.5325 if you have any questions.

Sincerely,

Richard C. Paul
Practice Fellow
rcpaul@fasb.org

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MINUTES OF THE MARCH 12, 2008 MEETING OF THE FASB EMERGING ISSUES TASK FORCE

Location: FASB Offices
401 Merritt 7
Norwalk, Connecticut

Wednesday, March 12, 2008
Starting Time: 11:00 a.m.
Concluding Time: 4:34 p.m.

Task Force Members Present:
Russell G. Golden (Chairman)
Mark M. Bielstein
James G. Campbell
Jack T. Ciesielski
Mitchell A. Danaher
Joseph Graziano
Jay D. Hanson[1]
Stuart H. Harden
Jan R. Hauser
David L. Holman
Carl Kampel
Matthew L. Schroeder
Ashwinpaul C. (Tony) Sondhi
Robert Uhl
James L. Kroeker (SEC Observer)

Task Force Members Absent:
Lawrence E. Weinstock
Tricia O'Malley (IASB Observer)

* For certain issues only.

[1] Mr. Hanson also served as the AcSEC Observer.

Others at Meeting Table:
Robert H. Herz, FASB Board Member
George J. Batavick, FASB Board Member
G. Michael Crooch, FASB Board Member
Thomas J. Linsmeier, FASB Board Member
Leslie F. Seidman, FASB Board Member
Larry W. Smith, FASB Board Member
*Donald M. Young, FASB Board Member
Mark LaMonte, Moody's Investor Services (incoming Task Force member)
Susan M. Cosper, FASB Senior Practice Fellow
Richard C. Paul, FASB Practice Fellow
Shelly C. Luisi, SEC Senior Associate Chief Accountant
Ashley W. Carpenter, SEC Professional Accounting Fellow
* David B. Elsbree Jr., FASB Practice Fellow
* David C. Leverenz, FASB Industry Fellow
* Shea H. Malcolm, FASB Practice Fellow
* Ronald W. Maples, FASB Practice Fellow
* Jeffery T. Nickell, FASB Practice Fellow
* Brian C. Stevens, FASB Practice Fellow
* Sheri E. Wyatt, FASB Practice Fellow
* Stacy E. Zecher, FASB Associate Practice Fellow

* For certain issues only.

ADMINISTRATIVE MATTERS

- The Task Force Chairman introduced Mr. James G. Campbell of Intel Corporation as a new member of the Task Force replacing Mr. Frank H. Brod. The Chairman also introduced Mr. Mark LaMonte of Moody's Investor Services, who will replace Mr. Jack T. Ciesielski as a member of the Task Force beginning with the June 2008 meeting. The Chairman thanked Messrs. Brod and Ciesielski for their service.

- Prior EITF meeting minutes: An FASB staff member solicited objections to the final minutes of the November 29, 2007 meeting. No objections were noted.

- The Task Force discussed the report on the EITF Agenda Committee meeting held on January 10, 2008. The Agenda Committee considered six issues and took the following actions:

  a. *Accounting for Share-Based Payment Transactions with Nonemployees*. The Agenda Committee decided not to add this issue to the EITF agenda.

  b. *Determining Whether a Money Market Mutual Fund is Designed to Create and Pass Along Interest Rate Risk for Purposes of Applying Interpretation 46(R).* The Agenda Committee decided not to add this issue to the EITF agenda. A Task Force member inquired about the Agenda Committee's decision on this issue and in response, the Task Force chairman stated that the staff is researching whether this and other issues regarding FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, require further standard-setting consideration.

  c. *Revenue Recognition for a Single Deliverable or a Single Unit of Account (with Multiple Deliverables) That Have Multiple Payment Streams.* The Agenda Committee decided to add this Issue to the EITF agenda. Refer to the discussion of EITF Issue No. 08-1, "Revenue Recognition for a Single Unit of Accounting," elsewhere in these minutes.

  d. *Revenue Recognition by Lessors on Maintenance Payments in Lease Arrangements.* The Agenda Committee decided to add this Issue to the EITF agenda. Refer to the discussion of EITF Issue No. 08-2, "Lessor Revenue Recognition for Maintenance Services," elsewhere in these minutes.

  e. *Accounting by Lessees for Maintenance Deposits under Lease Agreements.* The Agenda Committee decided to add this Issue to the EITF agenda. Refer to the discussion of EITF Issue No. 08-3, "Accounting by Lessees for Nonrefundable Maintenance Deposits," elsewhere in these minutes.

  f. *Consideration of Conforming Changes to Issue 98-5 and Tentative Conclusions in Issue 00-27*. The Agenda Committee decided to add consideration of conforming changes to EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion

Features or Contingently Adjustable Conversion Ratios," and transition guidance for those conforming changes to the EITF agenda. Refer to the discussion of Issue 98-5 (including EITF Issue No. 08-4, "Transition Guidance for Conforming Changes to Issue No. 98-5") elsewhere in these minutes. The Agenda Committee also recommended that the Task Force not finalize the remaining tentative conclusions in EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments." At the March 12, 2008 meeting, the Task Force agreed not to finalize the tentative conclusions in Issue 00-27. The Task Force also decided not to codify Issues 98-5 and 00-27 in a single abstract.

- Three comment letters on EITF Issue No. 07-4, "Application of the Two-Class Method under FASB Statement No. 128, *Earnings per Share*, to Master Limited Partnerships," were reported as received and distributed to the Task Force. Refer to the discussion of Issue 07-4 elsewhere in these minutes for Task Force consideration of those comment letters.

- June 2008 EITF meeting: An FASB staff member asked the Task Force to anticipate a day-and-a-half EITF meeting to be held on June 11 and 12, 2008.

- *Determining Whether Payments to Incentive Distribution Rights Holders in Master Limited Partnerships Represent Equity Distributions or Compensation Expense.* At the November 29, 2007 EITF meeting, the Task Force discussed the Agenda Committee's decision not to add this issue to the EITF agenda. After several Task Force members expressed concerns with that decision, the FASB staff was asked to prepare a proposed project plan for Task Force consideration. At the March 12, 2008 EITF meeting, the Task Force discussed that proposed project plan and decided not to add the issue to the EITF agenda.

- An FASB staff member announced that any consensuses-for-exposure reached at this meeting will be considered by the Board for ratification and exposure for public comment at the Board meeting on Wednesday, March 26, 2008. Any consensuses-for-exposure reached at prior meetings that are affirmed as consensuses at this meeting will also be considered by the Board for ratification at the Board meeting on Wednesday, March 26, 2008.

- The SEC Observer announced revisions to *EITF Abstracts*, Topic No. D-98, "Classification and Measurement of Redeemable Securities." The changes include the SEC staff's views regarding the interaction between Topic D-98 and FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*. Refer to the revised SEC staff announcement elsewhere in these minutes.

REVISED SEC STAFF ANNOUNCEMENT

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

Date Discussed: March 12, 2008

At the March 12, 2008 EITF meeting, the SEC Observer announced revisions to Topic D-98. The changes include the SEC staff's views regarding the interaction between Topic D-98 and FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*, as well as certain other clarifications.

For convenience, Topic D-98 is included below in its entirety: [added text is underlined and deleted text is ~~struck out~~.]

Topic No. D-98

Topic: Classification and Measurement of Redeemable Securities

Dates Discussed: July 19, 2001; May 15, 2003; March 17–18, 2004; September 15, 2005; March 16, 2006; September 7, 2006; March 15, 2007; June 14, 2007; March 12, 2008

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, derivative instruments,

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

noncontrolling interests[2], and share-based payment arrangements that are classified as equity pursuant to FASB Statement No. 123 (revised 2004), *Share-Based Payment*. [Note: See ~~paragraphs 24–25, 28–31, and 33–35 in the~~ Subsequent Developments section below.]

3. As noted in A~~ccounting 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."[3] 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 paragraphs 22–26 in the 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 SEC staff announcement, do not apply to those instruments after the effective date of Statement 150. ASR 268 and the interpretive guidance in this SEC 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 of an entity's equity securities for cash or other assets of the entity, should not result in a security being classified outside of permanent equity. In other words, if the payment of cash or other assets is required only from the distribution of net assets upon the final liquidation or

[2] Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (as amended by FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*), defines *noncontrolling interest* as "The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest." As indicated in paragraphs 40–41, the classification and measurement guidance in this SEC staff announcement applies to redeemable noncontrolling interests (provided the redemption feature is not considered a freestanding option within the scope of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*). Where relevant, specific guidance pertaining to redeemable noncontrolling interests has been included in this SEC staff announcement. Otherwise, the general guidance in this SEC staff announcement is applicable to redeemable noncontrolling interests.

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

termination of ~~the company~~an entity (which may be a less-than-wholly-owned consolidated subsidiary), then that potential event need not be considered when applying the rule. Other transactions are considered deemed liquidation events. For example, the contractual provisions of an equity security may require its redemption by the issuer upon the occurrence of a change-in-control that does not result in the liquidation or termination of the issuing entity, a delisting of the issuer's securities from an exchange, or the violation of a debt covenant. ~~However, d~~Deemed liquidation events that require (or permit at the holder's option) the redemption of only one or more particular class ~~or type~~ of equity security ~~to be redeemed~~for cash or other assets cause those securities to be classified outside of permanent equity. However, as a limited exception, a deemed liquidation event does not cause a particular class of equity security to be classified outside of permanent equity if all of the holders of equally and more subordinated equity securities of the entity would always be entitled to also receive the same form of consideration (for example, cash or shares) upon the occurrence of the event that gives rise to the redemption.

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. Some financial instruments issued in the form of shares that are not required to be classified as assets or liabilities under Statement 150 or other applicable GAAP are redeemable at the option of the holder or upon the occurrence of an event that is not solely within the control of the issuer. Upon redemption of these financial instruments (in other than an ordinary~~final~~ liquidation or deemed liquidation that meets the exception in paragraph 5), the issuer may be required or may have a choice to settle the contract by delivery of its own shares. For these instruments, the guidance in paragraphs 12–32 of Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," should be used to evaluate whether the issuer controls the actions or events necessary to issue the maximum number of shares that could be required to be delivered under share settlement of the contract. If the issuer does not control settlement by delivery of its own shares, cash settlement of the instrument would be presumed and the instrument would be classified as temporary equity. For example, if preferred shares are redeemable at the option of the holder (that is, puttable shares) and the issuer is permitted to settle the redemption amount in cash or by delivery of a variable number of its common shares with an equivalent value, the absence of a cap on the number of common shares that could be potentially issuable upon redemption requires classification of the preferred shares outside of permanent equity.

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~~ should be considered.

8. In another example, consider a preferred security with a deemed liquidation clause that provides that the security becomes redeemable if the common stockholders of the issuing company (that is, those immediately prior to a merger or consolidation) hold, immediately after such merger or consolidation, common stock representing less than a majority of the voting power of the outstanding common stock of the surviving corporation. This change-in-control provision would require the preferred security to be classified outside of permanent equity because a purchaser could acquire a majority of the voting power of the outstanding common 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 [Note: See paragraphs 33–35 in the Subsequent Developments section below.]
- 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~~ should 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.[4]

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."

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 paragraphs 22–26 in the 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 SEC staff announcement

[4] 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.

had originally applied. The SEC staff has the following observations about the ~~valuation~~measurement of redeemable ~~preferred stock~~equity securities that are~~is~~ not within the scope of Statement 150.

15. The SEC staff believes the initial carrying amount of a redeemable ~~preferred stock~~equity security should be its fair value at date of issue.[5] 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~~ should 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 maximum redemption amount at each balance sheet date.[6] 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).[7] 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 SEC staff will not object to either of the following accounting methods:

a. 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 FASB Statement No. 154, *Accounting Changes and Error Corrections*.
b. Recognize changes in the redemption value (for example, ~~market~~fair 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

[5] FASB Statement No. 141 (revised 2007), *Business Combinations*, and ARB 51 (as amended by Statement 160) provide guidance on the initial carrying amount of a noncontrolling interest. For equity securities that are issued by a parent, consistent with paragraph 17 of FASB Statement No. 157, *Fair Value Measurements*, the transaction price will generally represent the initial fair value of the equity security when the issuance occurs in an arm's-length transaction with an unrelated party and there are no other unstated rights or privileges. Paragraph 31 of this SEC staff announcement addresses the initial measurement of share-based payment arrangements with employees.
[6] If the maximum redemption amount is contingent on the fair value of the equity security at the redemption date, the amount reported outside of permanent equity should be calculated based on the fair value of the equity security as of the balance sheet date.
[7] See also Topic No. D-82, "Effect of Preferred Stock Dividends Payable in Common Shares on Computation of Income Available to Common Stockholders."

would view the end of the reporting period as if it were also the redemption date for the security.

16A. Regardless of the accounting method applied (see paragraphs 15 and 16), the SEC staff believes that reductions in the carrying amount of an equity security from the application of this SEC staff announcement are appropriate only to the extent that the registrant has previously recorded increases in the carrying amount of the equity security from the application of this SEC staff announcement.

17. 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 currently 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.

Reclassifications into Permanent Equity

17A. If classification of an equity security as temporary equity is no longer required (if, for example, a redemption feature lapses, or there is a modification of the terms of the security), the existing carrying amount of the equity security should be reclassified to permanent equity at the date of the event that caused the reclassification. Prior financial statements are not adjusted. Additionally, the SEC staff believes that it would be inappropriate to reverse any adjustments previously recorded to the carrying amount of the equity security (pursuant to paragraphs 13–17 of this SEC staff announcement) in conjunction with such reclassifications.

Deconsolidation of a Subsidiary

17B. Paragraph 36 of Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (as amended by FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*), provides guidance on the measurement of the gain or loss that is recognized in net income when a parent deconsolidates a subsidiary. As indicated in paragraph 36(a)(3) of ARB 51 (as amended by Statement 160), that gain or loss calculation is impacted by the carrying amount of any noncontrolling interest in the former subsidiary. Since adjustments to the carrying amount of a noncontrolling interest from the application of this SEC staff announcement do not initially enter into the determination of net income, the SEC staff believes that the carrying amount of the noncontrolling interest that is referred to in paragraph 36(a)(3) of ARB 51 (as amended by Statement 160) should similarly not include any adjustments made to that noncontrolling interest from the application of this SEC staff announcement. Rather, previously recorded adjustments to the carrying amount of a noncontrolling interest from the application of this SEC staff announcement should be eliminated in the same manner in which they were initially recorded (that is, by recording a credit to equity of the parent). The SEC staff encourages registrants to disclose the amount credited to equity of the parent as part of the disclosures required by paragraph 39 of ARB 51 (as amended by Statement 160).

Earnings per Share

18. *Preferred securities issued by a parent (or single reporting entity).* Regardless of the accounting method selected in paragraph 16 and the redemption terms (that is, fixed price or fair value), the resulting increases or decreases in the carrying amount of a redeemable security other than common stock ~~shall~~should be treated in the same manner as dividends on nonredeemable stock and ~~shall~~should 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~~should reduce or increase income ~~applicable~~available 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~~available to common stockholders on the face of the income statement should be provided. Additionally, Topic No. D-42, "The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock," and Topic No. D-53, "Computation of Earnings per Share for a Period That Includes a Redemption or an Induced Conversion of a Portion of a Class of Preferred Stock," provide guidance on the accounting at the date of a redemption or induced conversion of a preferred equity security.

19. *Common securities issued by a parent (or single reporting entity).* ~~Similarly, r~~Regardless of the accounting method selected in paragraph 16, the resulting increases or decreases in the carrying amount of redeemable common stock ~~shall~~should be treated in the same manner as dividends on nonredeemable stock and ~~shall~~should 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~~available to common stock~~share~~holders. Rather, the SEC staff believes that to the extent that a common shareholder has a contractual right to receive at share redemption (in other than ~~upon~~an ordinary liquidation ~~events~~or deemed liquidation that meets the exception in paragraph 5) an amount that is other than the fair value of such shares, then that common shareholder has, in substance, received a distribution different from other common shareholders. 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.[8] For common stock redeemable at fair value[9], 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 distribution different from other common shareholders.[10]

19A. *Noncontrolling interests.* Paragraph 33 of ARB 51 (as amended by Statement 160) indicates that changes in a parent's ownership interest while the parent retains control of its subsidiary are accounted for as equity transactions, and do not impact net income or comprehensive income in the consolidated financial statements. Consistent with paragraph 33 of ARB 51 (as amended by Statement 160), an adjustment to the carrying amount of a noncontrolling interest from the application of this SEC staff announcement does not impact net income or comprehensive income in the consolidated financial statements. Rather, such adjustments are treated akin to the repurchase of a noncontrolling interest (although they may be recorded to retained earnings instead of additional paid-in capital). The SEC staff believes the guidance in paragraphs 18 and 19 of this SEC staff announcement should be applied to noncontrolling interests as follows:

a. *Noncontrolling interest in the form of preferred securities.* The impact on income available to common stockholders of the parent arising from adjustments to the carrying amount of a redeemable noncontrolling interest other than common stock depends upon whether the redemption feature in the equity security was issued, or is guaranteed, by the parent. If the redemption feature was issued, or is guaranteed, by the parent, the entire adjustment under paragraph 18 reduces or increases income available to common stockholders of the parent. Otherwise, the adjustment is attributed to the parent and the noncontrolling interest in accordance with paragraph 62 (and Illustration 7) of Statement 128.

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[8] 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." The SEC staff believes that there are two acceptable approaches for allocating earnings under the two-class method when a common security is redeemable at other than fair value. The registrant may elect to: (a) treat the entire periodic adjustment to the security's carrying amount (from the application of this SEC staff announcement) as being akin to an actual dividend or (b) treat only the portion of the periodic adjustment to the security's carrying amount (from the application of this SEC staff announcement) that reflects a redemption in excess of fair value as being akin to an actual dividend. Under either approach, decreases in the security's carrying amount should be reflected in the application of the two-class method only to the extent they represent recoveries of amounts previously reflected in the application of the two-class method.

[9] Common stock that is redeemable based on a specified formula is considered to be redeemable at fair value if the formula is designed to equal or reasonably approximate fair value. The SEC staff believes that a formula based solely on a fixed multiple of earnings (or other similar measure) is not considered to be designed to equal or reasonably approximate fair value.

[10] Similarly, this SEC staff announcement does not require application of the two-class method when share-based payment awards granted to employees are redeemable at fair value (provided those awards are in the form of common shares or options on common shares). However, those share-based payment awards may still be subject to the two-class method pursuant to the guidance in paragraph 60 of Statement 128 and Issue 03-6. [Note: See paragraphs 27–31 in the Subsequent Developments section below.]

b. *Noncontrolling interest in the form of common securities.* Adjustments to the carrying amount of a noncontrolling interest issued in the form of a common security to reflect a fair value redemption feature do not impact earnings per share. Adjustments to the carrying amount of a noncontrolling interest issued in the form of a common security to reflect a non-fair value redemption feature do impact earnings per share; however, the manner in which those adjustments reduce or increase income available to common stockholders of the parent may differ.[11] If the terms of the redemption feature are fully considered in the attribution of net income under paragraph 30 of ARB 51 (as amended by Statement 160), application of the two-class method is unnecessary. If the terms of the redemption feature are not fully considered in the attribution of net income under paragraph 30 of ARB 51 (as amended by Statement 160) application of the two-class method at the subsidiary level is necessary in order to determine net income available to common stockholders of the parent.

Transition

20. When this SEC staff 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 APB Opinion No. 20, *Accounting Changes*.

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 SEC staff announcement). Prior period earnings per share amounts presented for comparative purposes should be retroactively adjusted to conform to the guidance.

21A. At the March 12, 2008 meeting, the SEC Observer announced that clarifications were made to this SEC staff announcement. Registrants should apply the SEC staff's views in paragraphs 16A, 17A, and footnote 9 of this SEC staff announcement no later than the first fiscal year beginning on or after December 15, 2008. A change in a registrant's application of the two-class method (see footnote 8) should be accounted for in accordance with Statement 154. The SEC staff's views on the accounting for noncontrolling interests (paragraphs 17B and 19A) should be applied following the effective date of Statement 160. [Note: See paragraphs 40–41 in the Subsequent Developments section below.]

[11] ARB 51 (as amended by Statement 160) does not provide detailed guidance on the attribution of net income to the parent and the noncontrolling interest. The SEC staff understands that when a noncontrolling interest is redeemable at other than fair value some registrants consider the terms of the redemption feature in the calculation of net income attributable to the parent (as reported on the face of the income statement), while others only consider the impact of the redemption feature in the calculation of income available to common stockholders of the parent (which is the control number for earnings per share purposes).

Subsequent Developments

Statement 150

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. Freestanding financial 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 SEC staff announcement no longer apply for those instruments after the effective date of Statement 150. Additionally, freestanding financial instruments that were previously classified as temporary equity under Issue 00-19 are no longer subject

to temporary equity classification under ASR 268 and ~~Topic D-98~~this SEC staff announcement because those freestanding financial instruments are now within the scope of Statement 150. However, Issue 00-19 continues to apply to embedded derivative instruments indexed to, and potentially settled in, a company's own stock. Accordingly, when a hybrid financial instrument that is not classified as an asset or liability under Statement 150 or other applicable GAAP contains an embedded derivative within the scope of Issue 00-19, the registrant ~~must~~ should consider ASR 268 and this SEC staff announcement~~Topic D-98~~ to determine whether:

- The hybrid financial instrument is required to be classified and measured as temporary equity when the embedded derivative *is not* separated under Statement 133, or
- The host contract is required to be classified and measured as temporary equity when the embedded derivative *is* separated under Statement 133.

25. At the November 12–13, 2003 meeting, the SEC Observer announced the SEC staff's position relating to the application of this SEC staff announcement~~Topic D-98~~ to certain mandatorily redeemable securities for which the relevant portions of Statement 150 were recently deferred in FASB Staff Position 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 this SEC staff announcement~~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 this SEC staff announcement~~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~~ income available to common stock~~share~~holders in the calculation of earnings per share.

Statement 123(R)

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 this SEC staff announcement~~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, *Interaction Between FASB Statement No. 123(R), and Certain SEC Rules and Regulations Regarding the Valuation of Share-Based Payment Arrangements for Public Companies,* the SEC staff clarified that registrants ~~must~~ should evaluate whether the terms of instruments granted in conjunction with share-based payment arrangements with employees that are not classified as liabilities under Statement 123(R) result in the need to present certain amounts outside of permanent equity in accordance with ASR 268 and this SEC staff announcement~~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 SEC staff to require net cash settlement for purposes of applying ASR 268 and this SEC staff announcement~~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.

31. At the March 16, 2006 meeting, the SEC Observer clarified the SEC staff's position on the application of this SEC staff announcement~~Topic D-98~~ to certain share-based payment arrangements with employees. The SEC staff believes that for options or similar instruments granted in conjunction with share-based payment arrangements with employees for which the terms may permit redemption of the option or underlying share, the initial amount classified outside of permanent equity should be based on the redemption provisions of the instrument.[12] For example, upon issuance of a fully vested option that allows the holder to put the option back to the issuer at its intrinsic value upon a change in control, an amount representing the intrinsic value of the option at the date of issuance should be presented outside of permanent equity. The guidance in paragraphs 15–17 should be followed to determine the amount of any subsequent adjustments.[13]

Statement 155

32. In February 2006, the FASB issued FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*. Statement 155 establishes standards designed to simplify accounting for certain hybrid financial instruments by permitting fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. Statement 155 amends paragraph 16 of Statement 133 to permit this election, while footnote 6bb of Statement 133 clarifies that the guidance applies to hybrid financial instruments that are classified as assets and liabilities and does not apply to hybrid financial instruments classified in permanent or temporary equity, which are instruments described in paragraph 8 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*. Therefore, the guidance in this SEC staff announcement~~Topic~~ continues to be applicable for hybrid financial instruments classified in permanent or temporary stockholders' equity.

FSP EITF 00-19-2

33. In December 2006, the FASB issued FASB Staff Position EITF 00-19-2, "Accounting for Registration Payment Arrangements." FSP EITF 00-19-2 addresses the issuer's accounting for registration payment arrangements and specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement (as defined in the FSP), whether issued as a separate agreement or included as a provision of a

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[12] As discussed in the Interpretive Response to Question 2 in Section E of SAB 107, the amount presented in temporary equity at each balance sheet date should take into account the proportion of consideration received in the form of employee services.

[13] Registrants should also consider the guidance in FASB Staff Position FAS 123(R)-4, "Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event," when evaluating the classification of options or similar instruments whose terms may permit redemption of the option or underlying share.

financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, *Accounting for Contingencies.* Additionally, paragraph 8 of FSP EITF 00-19-2 states that a financial instrument subject to a registration payment arrangement should be recognized and measured in accordance with other applicable GAAP without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. At the March 15, 2007 meeting, the SEC Observer announced the SEC staff's position relating to the interaction of the financial statement classification and measurement guidance in this SEC staff announcement~~Topic D-98~~ and the guidance for registration payment arrangements in FSP EITF 00-19-2. Consistent with the guidance in FSP EITF 00-19-2, the SEC staff believes that the guidance in this SEC staff announcement~~Topic D-98~~ should be applied to a financial instrument subject to a registration payment arrangement without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement (that is, the registration payment arrangement is considered to be a separate unit of account that does not impact the classification and measurement of the related financial instrument under this SEC staff announcement~~Topic D-98~~). However, for purposes of applying this SEC staff announcement~~Topic D-98~~ to a financial instrument with any other related arrangement that is outside the scope of FSP EITF 00-19-2, the SEC staff believes that a conclusion that the related arrangement is a separate unit of account should not be based on an analogy to the guidance in FSP EITF 00-19-2.

34. The SEC staff announcement in paragraph 33 should be applied following the effective date of FSP EITF 00-19-2. If upon adoption of FSP EITF 00-19-2, a registrant determines that a financial instrument subject to a registration payment arrangement should be reclassified from temporary equity to permanent equity, the registrant should reclassify the related financial instrument following the guidance in paragraph 19 of FSP EITF 00-19-2. Any difference between the carrying amount of the instrument recorded as temporary equity prior to adoption of FSP EITF 00-19-2 and the carrying amount reclassified to permanent equity upon adoption of FSP EITF 00-19-2 should be included in the cumulative effect adjustment to the opening balance of retained earnings, or other appropriate components of equity or net assets in the statement of financial position. In the period of reclassification, that difference (if any) should not be deducted from or added to ~~net earnings~~income available to common stock~~share~~holders in the calculation of earnings per share.

35. If a registrant has adopted FSP EITF 00-19-2 and issued its financial statements prior to March 15, 2007 (the date of this SEC staff announcement) using a reasonable methodology that is inconsistent with the SEC staff announcement described in paragraph 34, those prior period financial statements

should not be restated. However, the earnings per share amounts reported in those prior-period financial statements presented for comparative purposes in the registrant's next interim or annual financial statements should be retrospectively adjusted (if necessary) to conform to the guidance in paragraph 34.

Statement 133

36. At the March 15, 2007 meeting, the SEC Observer announced the SEC staff's position relating to the determination of whether the characteristics of a host contract related to a hybrid financial instrument issued in the form of a share are more akin to a debt instrument or more akin to an equity instrument. This SEC staff announcement also discusses the interaction of the financial statement classification guidance in this SEC staff announcement~~Topic D-98~~ and the guidance in paragraphs 12(a) and 60 of Statement 133. The SEC staff's position regarding these matters is discussed in Topic No. D-109, "Determining the Nature of a Host Contract Related to a Hybrid Financial Instrument Issued in the Form of a Share under FASB Statement No. 133."

Statement 159

37. In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. Statement 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Paragraph 8(f) of Statement 159 prohibits an issuer from electing the fair value option for financial instruments that are, in whole or in part, classified as a component of shareholder's equity (including "temporary equity").

38. The SEC staff has previously not objected to liability classification on the balance sheet for certain financial instruments (or host contracts) that meet the conditions for temporary equity classification under ASR 268 and this SEC staff announcement~~Topic D-98~~. In these circumstances, registrants recorded dividends and changes in carrying amount currently in earnings, rather than recording such items as direct adjustments to retained earnings. At the June 14, 2007 meeting, the SEC Observer announced the SEC staff's position regarding these classification practices and the related impact on the guidance in paragraph 8(f) of Statement 159. The SEC staff will no longer accept liability classification for financial instruments (or host contracts) that meet the conditions for temporary equity classification under ASR 268 and this SEC staff announcement~~Topic D-98~~. Consistent with SEC Regulation S-X, Articles 5-02, 7-03, and 9-03, these financial instruments should be classified on the balance sheet between captions for liabilities and shareholder's equity. As a consequence, the fair value option may not be applied to any financial instrument (or host contract) that meets the conditions for temporary equity classification under ASR 268 and this SEC staff announcement~~Topic D-98~~. The measurement guidance in this SEC staff announcement~~Topic D-98~~ applies to these financial instruments.

39. The SEC staff announcement in paragraph 38 should be applied prospectively to all affected financial instruments (or host contracts) that are entered into, modified, or otherwise subject to a remeasurement (new basis) event in the registrant's first fiscal quarter beginning after September 15, 2007. Subsequent to initial adoption of the guidance in paragraph 38, a registrant should not initially apply hedge accounting or initially elect the fair value option for an affected financial instrument (or host contract) that continues to be classified on the balance sheet as a liability. That is, while an existing financial instrument (or host contract) that otherwise meets the conditions for classification as temporary equity may continue to be classified as a liability when the guidance in paragraph 38 is adopted prospectively, that financial instrument (or host contract) would not be eligible for initial application of the fair value option under Statement 159 or initial adoption of hedge accounting in fiscal quarters beginning after September 15, 2007. As an alternative to prospective application, a registrant may retrospectively apply the guidance in paragraph 38 to all prior financial reporting periods in accordance with paragraphs 7–10 of Statement 154. Regardless of the method of transition, the disclosures in paragraph 24 of Statement 154 should be provided. Earlier adoption is permitted.

Statement 160 (an amendment of ARB 51)

40. In December 2007, Statement 160 was issued. Statement 160 amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. As indicated in paragraph 27(c) of ARB 51 (as amended by Statement 160), ASR 268 provides guidance on the classification of a financial instrument issued by a subsidiary. Application of ASR 268 and this SEC staff announcement to a redeemable noncontrolling interest is consistent with the SEC staff's longstanding position.

41. Statement 160 does not provide guidance for instruments within the scope of ASR 268 (see paragraph B35 of Statement 160). At the March 12, 2008 meeting, the SEC Observer announced that clarifications were made to this SEC staff announcement to address its interaction with Statement 160. While those amendments are not expected to result in significant changes in existing accounting practices, paragraph 21A of this SEC staff announcement provides transition guidance for the amendments made to paragraphs 17B and 19A.[14] Additionally, the SEC staff is aware that some registrants have not previously applied the measurement guidance in paragraphs 13–17 of this SEC staff announcement when a noncontrolling interest issued in the form of a common security is redeemable at fair value. Those registrants should initially apply that

[14] That transition guidance is intended to include the impact that footnote 9 of this SEC staff announcement may have on the determination of whether a noncontrolling interest is redeemable at fair value.

measurement guidance no later than the effective date of Statement 160. Transition should be applied consistent with the transition guidance in paragraph 5(a) of Statement 160 (that is, retrospectively for all periods presented).[15] In periods preceding such initial adoption, those registrants should disclose the redemption amount of those securities on the face of the balance sheet, and provide disclosures of the pertinent terms and conditions of those securities in the footnotes.

[15] Consistent with paragraph 19A(b) of this SEC staff announcement, the initial application will not impact previously reported earnings per share amounts.

Issue No. 98-5

Title: Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios

Dates Discussed: May 21, 1998; July 23, 1998; September 23–24, 1998; November 18–19, 1998; January 21, 1999; March 24–25, 1999; May 19–20, 1999; March 12, 2008

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

FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

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

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

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

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

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

FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

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

APB Opinion No. 20, *Accounting Changes*

APB Opinion No. 21, *Interest on Receivables and Payables*

APB Opinion No. 25, *Accounting for Stock Issued to Employees*

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*

AICPA Accounting Interpretation, *Interest on Receivables and Payables*, of APB Opinion No. 21

SEC Staff Accounting Bulletin No. 68, *Increasing Rate Preferred Stock*

EITF Issue No. 85-17, "Accrued Interest upon Conversion of Convertible Debt"

EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments"

EITF Issue No. 08-4, "Transition Guidance for Conforming Changes to Issue No. 98-5"

Introduction

1. Certain consensuses in Issue 00-27 nullified portions of the guidance in Issue 98-5. A general status update that included transition guidance was added to Issue 98-5 to acknowledge the issuance of Issue 00-27. However, the portions of Issue 98-5 that were nullified by Issue 00-27 were not specifically identified in Issue 98-5, nor were the illustrative examples in Issue 98-5 updated for the effects of Issue 00-27.

2. Furthermore, Statement 150 was issued in May 2003. Instruments within the scope of Statement 150 are accounted for pursuant to the guidance in that Statement, not the guidance in Issues 98-5 or 00-27. A status update was added to Issue 00-27 clarifying that instruments within the scope of Statement 150 are no longer within the scope of Issue 00-27. However, a status update was not included in Issue 98-5, even though instruments within the scope of Statement 150 are no longer within the scope of Issue 98-5. In addition, certain examples in Issue 98-5 appear to illustrate instruments that are within the scope of Statement 150 and therefore should have been nullified.

3. The FASB staff was informed by a constituent that some companies were following the guidance in Issue 98-5 that had been nullified by either Issue 00-27 or Statement 150. That constituent requested removal of the nullified guidance from Issue 98-5 and incorporation of the appropriate references to the current guidance.

4. At the November 29, 2007 EITF meeting, the FASB staff proposed (a) to replace the superseded guidance in Issue 98-5 with the current guidance in Issue 00-27, (b) to update the illustrative examples in Issue 98-5 to reflect the current guidance in Issue 00-27, (c) to add status update discussion in Issue 98-5 relating to Statement 150, (d) to delete the illustrative examples in Issue 98-5 that are within the scope of Statement 150, and (e) to delete an illustrative example in Issue 98-5 that requires interpretations of subsequently issued accounting literature that are not currently reflected in that example.

5. Also at the November 29, 2007 EITF meeting, certain Task Force members noted concerns with the format of the changes and asked the staff to consider modifications that would retain the historical guidance and include the current amending guidance in the abstract and examples. The Task Force also asked the staff to consider whether transition guidance should be provided for the conforming changes to Issue 98-5. Additionally, the Task Force believed that a portion of the status update that was proposed for Issue 98-5 was providing interpretive guidance that should not be included in the status update and that the issue should be specifically considered by the Task Force instead.

Issues

6. The issues are:

Issue 1— Whether transition guidance should be provided for conforming changes to Issue 98-5

Issue 1(a)— What the appropriate effective date and transition guidance for the conforming changes to Issue 98-5 should be

Issue 2— Whether convertible instruments that have terms that provide for settlement through the issuance of (a) a variable number of shares with a fixed monetary amount if settlement occurs when the share price is less than a certain amount or (b) a fixed number of shares if settlement occurs when the share price is equal to or greater than a certain amount, should be evaluated as having (1) a single compound embedded feature (that is, one embedded feature with the characteristics of a share-settled "put warrant") or (2) two separate embedded features (that is, an embedded put option and an embedded conversion feature).

Current EITF Discussion

7. At the March 12, 2008 EITF meeting, the Task Force decided to provide transition guidance for the conforming changes to Issue 98-5 relating to Issue 00-27 and Statement 150.

8. The Task Force reached a consensus-for-exposure that the conforming changes to Issue 98-5 shall be effective for financial statements issued for fiscal years ending after December 15, 2008, with earlier application permitted. The impact of applying the conforming changes, if any, shall be presented retrospectively with the cumulative-effect of the change being reported in retained earnings in the statement of financial position as of the beginning of the first period presented (retrospective application). Additionally, any transition impact of applying these conforming changes shall comply with the disclosure requirements of Statement 154 for changes in accounting principles.

9. The Task Force discussed Issue 2, but decided not to include any additional guidance because that issue has broader implications and seems to be beyond the scope of providing conforming changes to Issue 98-5. After further consideration, it became clear that the guidance on determining what constitutes a "conversion option" for financial instruments that have terms that provide for settlement through the issuance of (a) a variable number of shares with a fixed monetary amount if settlement occurs when the share price is less than a certain amount or (b) a fixed number of shares if settlement occurs when the share price is equal to or greater than a certain amount, may have a significant impact on other transactions that are within the scope of Statement 133 that have not been contemplated. Therefore, the Task Force decided not to address Issue 2.

10. As a result of its decision to not address Issue 2, the Task Force agreed that Case 1(d) in Exhibit 98-5A shall be nullified as part of the conforming changes because it illustrates the accounting for a financial instrument with terms that provide for settlement through the issuance of (a) a variable number of shares with a fixed monetary amount if settlement occurs when the share price is less than a certain amount or (b) a fixed number of shares if settlement occurs when the share price is equal to or greater than a certain amount. The illustration in Case 1(d) requires interpretations of other accounting literature that were issued subsequent to Issue 98-5 and were not reflected in that example. As a result, Case 1(d) will be nullified as part of the conforming changes.

11. Appendix 98-5A presents the proposed Exhibit 00-27B, which reflects the amendments to Issue 98-5 that are the result of the consensus on Issue 00-27 (added text is underlined and deleted text is ~~struck out~~). Exhibit 00-27B was presented to the Task Force for its consideration and no objections were noted. Exhibit 00-27B will be included with the abstract for Issue 00-27.

12. Appendix 98-5B presents a draft abstract for Issue 08-4, which was developed to reflect the Task Force's consensuses-for-exposure regarding the effective date and transition guidance for the conforming changes to Issue 98-5 that result from Issue 00-27 and Statement 150. Attached to this Issue is Exhibit 08-4A, which illustrates all of the conforming changes to Issue 98-5 (added text is underlined and deleted text is ~~struck out~~).

Board Ratification

13. At its March 26, 2008 meeting, the Board ratified both the amendments to Issue 98-5 that result from Issue 00-27 and Statement 150 and the consensus-for-exposure reached by the Task Force contained in Issue 08-4. The Board also approved the issuance of a draft abstract for a public comment period.

Status

14. The draft abstract for Issue 08-4 will be posted to the FASB website after April 1, 2008. Comments on the draft abstract are due by May 5, 2008.

Appendix 98-5A

EXHIBIT 00-27B TO BE ADDED TO ISSUE 00-27

Exhibit 00-27B

ILLUSTRATION OF THE AMENDMENTS TO ISSUE 98-5 BY ISSUE 00-27

1. This exhibit illustrates the amendments to Issue 98-5 resulting from the consensus in Issue 00-27 as follows: [Added text is underlined and deleted text is ~~struck out~~.]

   EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," is amended as follows: [Added text is underlined and deleted text is ~~struck out~~.]

   a. Footnote 1 to paragraph 1:

      ~~The commitment date is the date when an agreement as to terms has been reached and the investor is committed to purchase the convertible securities based on those terms (that is, performance by the investor is probable because of sufficiently large disincentives for nonperformance). In certain cases, the securities may be purchased by a number of investors, such as a group of lenders participating in a syndicate. In those situations, the latest commitment date for the group or issuance date for each individual security, whichever comes first, should be considered the commitment date.~~

      The commitment date is defined as the date when an agreement has been reached 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.

The Task Force observed that if an agreement includes subjective provisions that permit either party to rescind its commitment to consummate the transaction (for example, a provision that allows an investor to rescind its commitment to purchase a convertible instrument in the event of a material adverse change in the issuer's operations or financial condition or a provision that makes the commitment subject to customary due diligence or shareholder approval), a commitment date should not occur until the provisions expire or the convertible instrument is issued, whichever is earlier.

b. Paragraph 6:

The Task Force observed that in certain circumstances, the intrinsic value of the beneficial conversion feature may be greater than the proceeds allocated to the convertible instrument. In those situations, the Task Force reached a consensus that the amount of the discount assigned to the beneficial conversion feature is limited to the amount of the proceeds allocated to the convertible instrument. [Note: This consensus has been partially nullified by Statement 133. See STATUS section.] ~~Except as provided in paragraph 10 below, the discount assigned to the convertible instrument, if any, should be amortized over the period to the security's earliest conversion date.~~ For convertible instruments that have a stated redemption date, a discount resulting from recording a beneficial conversion option shall be required to be amortized from the date of issuance to the stated redemption date of the convertible instrument, regardless of when the earliest conversion date occurs. For convertible instruments that do **not** have a stated redemption date, such as perpetual preferred stock, a discount resulting from the accounting for a beneficial conversion option shall be amortized from the date of issuance to the earliest conversion date.

c. Paragraph 8 and its related footnote 5:

For convertible preferred securities, any recorded discount resulting from allocation of proceeds to the beneficial conversion feature is analogous to a dividend and should be recognized as a return to the preferred shareholders ~~over the minimum period from the date of issuance to the date at which the preferred shareholders can realize that return (that is, through the date of earliest conversion)~~[5] using the effective yield method.

[5]~~For those preferred securities that are convertible at the date of issuance, the Task Force observed that the discount would be fully amortized through retained earnings at the date of issuance.~~

d. Paragraph 9 and its related footnote 6:

> For convertible debt securities, any recorded discount resulting from allocation of proceeds to the beneficial conversion feature should be recognized as interest expense ~~over the minimum period from the date of issuance to the date at which the debtholder can realize that return (that is, through the date of earliest conversion[6])~~ using the effective yield method.
>
> ~~[6]For those debt securities that are convertible at the date of issuance, the Task Force observed that the discount would be fully amortized through interest expense at the date of issuance.~~

e. Paragraphs 10 and 10A:

> 10. In situations in which the instrument incorporates a multiple-step discount (for example, an instrument that provides for a 15 percent discount to the market price after 3 months, a 25 percent discount after 6 months, a 35 percent discount after 9 months, and a 40 percent discount after 1 year), the basic accounting model described above is modified. For those types of convertible securities, the Task Force reached a consensus that the computation of the intrinsic value should be made using the conversion terms that are most beneficial to the investor. <u>If the convertible instrument has a stated redemption date, the resultant discount should be amortized from the date of issuance to the stated redemption date of the convertible instrument, regardless of when the earliest conversion date occurs (in the example noted above, the discount would be 40 percent and the amortization period would be from issuance to the stated redemption date).</u>
>
> <u>10A.</u> ~~The resultant discount should be~~ <u>For convertible instruments that do **not** have a stated redemption date, the resultant discount should be</u> amortized over the minimum period in which the investor can recognize that return (in the example noted above, the discount would be 40 percent and the amortization period would be 1 year). However, amortization recognized may require adjustment to ensure that the discount amortized at any point in time is not less than the amount the holder of the instrument could obtain if conversion occurred at that date. That is, at the end of 3 months, at least the 15 percent discount should have been recognized. This method can be expressed as requiring cumulative amortization equal to the *greater of* (a) the amount derived using the effective yield method based on the conversion terms most beneficial to the investor or (b) the amount of discount which the investor can realize at that interim date.

f. Paragraph 11 and footnote 6a:

In circumstances in which the instrument is converted prior to amortization of the full amount of the discount, the remaining unamortized discount at the date of conversion should be ~~included in the carrying value of the convertible security that is transferred to equity at the date of conversion.~~ immediately recognized as interest expense or as a dividend, as appropriate.[6a] If the amount of unamortized discount is recognized as an expense (because the convertible instrument was in debt form), the expense should not be classified as extraordinary. If, however, the amount of discount amortized exceeds the amount the holder realized because conversion occurred at an earlier date, the Task Force agreed that no adjustment should be made to amounts previously amortized.

[6a] For convertible debt that does not include a beneficial conversion option, Accounting Interpretation 1 of Opinion 26 and Issue 85-17 continue to apply. Those pronouncements state that the net carrying amount of the convertible debt, including any unamortized premium or discount, is credited to equity upon conversion.

g. Paragraph 13:

The Task Force also discussed the accounting for (a) a security that becomes convertible only upon the occurrence of a future event outside the control of the holder and (b) a security that is convertible from inception but contains conversion terms that change upon the occurrence of a future event. The Task Force reached a consensus that any contingent beneficial conversion feature should be measured ~~at~~ using the commitment date stock price but not recognized in earnings until the contingency is resolved.

h. Paragraph 17A is added as follows:

Issue 00-27 addresses a number of practice issues raised about the application of the Issue 98-5 model. The Task Force reached a consensus on portions of Issue 00-27 at the November 15–16, 2000 meeting.

i. Paragraphs 18 and 18A, also paragraphs 18B and 18C are added as follows:

The original consensuses reached in Issue 98-5 are applicable to instruments issued after May 20, 1999 and prior to November 16, 2000 (unless a commitment date, as defined under Issue 98-5, occurred before November 16, 2000, in which case Issue 98-5 applies to those instruments). For instruments issued after November 16, 2000, for which a commitment date, as originally defined in Issue 98-5, has not occurred prior to November 16, 2000, the consensuses in Issue ~~No.~~ 00-27~~, "Application of Issue No. 98-5 to Certain Convertible Instruments,"~~ should be applied. Issue 98-5 originally defined a commitment date as the date when an agreement as to terms has been reached and the investor is committed to purchase the convertible securities based on those terms (that is, performance by the investor is probable because of sufficiently large disincentives for nonperformance). In certain cases, the securities may be purchased by a number of investors, such as a group of lenders participating in a syndicate. In those cases, the latest commitment date for the group or issuance date for each individual security, whichever comes first, should be considered the commitment date.

18A. During the discussions of Issue 00-27, the SEC Observer stated that the consensus on Issue 1 of Part II of Issue 00-27 must be applied to all transactions subject to Issue 98-5, including those transactions for which a commitment date occurred before November 16, 2000. The effect, if any, of initial application of the consensus on Issue 1 of Part II to all prior transactions (including existing, terminated, and converted) subject to Issue 98-5 should be reported as of the beginning of a registrant's quarter that includes the date of the Issue 00-27 consensus (November 16, 2000) in a manner similar to the cumulative effect of a change in accounting principle in accordance with Opinion 20.

18B. Cases 1(a), 1(b), 2, 3, 4, and 6 in Exhibit 98-5A have been amended to reflect the guidance provided for in Issue 00-27.

18C. Refer to Exhibit 00-27B of Issue 00-27 for an illustration of the amendments to Issue 98-5 by Issue 00-27.

j. Exhibit 98-5A, Case 1(a):

Assumptions:

1. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance.
2. Convertible at date of issuance.
3. Convertible at $40 per share.
4. Fair value (FV) of common at commitment date equals $50 per share.

Calculation:

FV at commitment date	$50
Conversion price (stated and will not change)	$40
Intrinsic value of beneficial conversion feature	$250,000[7]
Amount to record at date of issuance	**$250,000**

The beneficial conversion feature is calculated at its intrinsic value (that is, the difference between the conversion price and the fair value of the common stock into which the debt is convertible, multiplied by the number of shares into which the debt is convertible) at the commitment date. A portion of the proceeds from issuance of the convertible debt, equal to the intrinsic value, is then allocated to additional paid-in capital (APIC). Because the debt ~~is convertible at the date of issuance, the debt discount is charged to interest expense at the date of issuance.~~ has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.

Entry at date of issuance:

Cash	$1,000,000	
Debt discount ~~Interest expense~~	250,000	
Debt		$1,000,000
APIC		250,000

[7]Convertible into 25,000 shares (1,000,000 ÷ 40) with an intrinsic value of $10 (50 – 40) or overall: (1,000,000 ÷ 40) × (50 – 40).

k. Exhibit 98-5A, Case 1(b):

Assumptions:

1. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance.
2. Convertible in one year.
3. Convertible at $40 per share.
4. FV of common at commitment date equals $50 per share.

Calculation:

FV at commitment date	$50
Conversion price (stated and will not change)	$40
Intrinsic value of beneficial conversion feature	$250,000[8]
Amount to record over period to convert	**$250,000**

The beneficial conversion feature is calculated at its intrinsic value at the commitment date (that is, the difference between the conversion price and the fair value of the common stock into which the debt is convertible, multiplied by the number of shares into which the debt is convertible). A portion of the proceeds from issuance of the convertible debt, equal to the intrinsic value, is then allocated to additional paid-in capital. Because the debt ~~is convertible in one year, the debt discount is amortized to interest expense over one year using the interest method.~~ has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.

Entry at date of issuance:

Cash	$1,000,000	
Debt discount	250,000	
Debt		$1,000,000
APIC		250,000

[8](1,000,000 ÷ 40) × (50 – 40)

l. Exhibit 98-5A, Case 2:

Assumptions:

1. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance.
2. Convertible upon an initial public offering (IPO).
3. Convertible at 80 percent of stock price at commitment date (that is, $40).
4. FV of common at commitment date equals $50 per share.

Calculation:

IPO price	**$50**	**$60**	**$70**
Stock price at commitment date	$50	$50	$50
80% of stock price at commitment date	$40	$40	$40
Intrinsic value of beneficial conversion feature at commitment date	$250,000[15]	$250,000[16]	$250,000[17]

The instrument is not convertible at the commitment date; however, it will become convertible and that conversion feature will be beneficial if an IPO is completed. The intrinsic value of the beneficial conversion feature is calculated at the commitment date using the stock price as of that date, that is, $250,000. However, that amount would only be recorded at the date an IPO is completed. If the IPO were completed on the third anniversary of the debt issuance, the discount amount would be recorded at that date and amortized over a two-year period ending on the stated redemption date of the debt.

Entry at issuance:

Cash	$1,000,000	
Debt		$1,000,000

Entry at IPO:

Debt discount ~~Interest Expense~~	$250,000	
APIC		$250,000

[15](1,000,000 ÷ 40) × (50 – 40)
[16](1,000,000 ÷ 40) × (50 – 40)
[17](1,000,000 ÷ 40) × (50 – 40)

m. Exhibit 98-5A, Case 3:

Assumptions:

1. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance.
2. Convertible at date of issuance.
3. Convertible at 80 percent of stock price at commitment date (that is, $40).
4. FV of common at commitment date equals $50 per share.
5. If there is an IPO, the conversion feature adjusts to the lesser of $30 or 80 percent of the IPO price.

Calculation:

FV at commitment date	$50
Conversion price at commitment date	$40
Intrinsic value of basic beneficial conversion feature at commitment date	$250,000[18]
Conversion price at contingency resolution	unknown
~~Most beneficial conversion price at commitment date~~	~~$30~~
Intrinsic value of contingent beneficial conversion feature at commitment date	unknown~~$666,667~~[19]
~~Amount recorded at issuance date~~	~~250,000~~
~~Additional intrinsic value of contingent beneficial conversion feature at commitment date~~	~~$416,667~~

This instrument includes a "basic" beneficial conversion feature that is not contingent upon the occurrence of a future event and a contingent beneficial conversion feature. Accordingly, the intrinsic value of the basic beneficial conversion feature of $250,000 is calculated at the commitment date and recorded at the issuance date. Because the debt ~~is convertible at the date of issuance, the debt discount is charged to interest expense at the date of issuance.~~ has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.

~~The amount of the contingent beneficial conversion feature also is calculated at the commitment date using the terms most advantageous to the investor, based on the facts available at that date. In this instance, the most beneficial conversion price at the commitment date is $30 per share. Accordingly, the beneficial conversion feature is calculated using the $30 per-share conversion price resulting in a contingent beneficial conversion amount of $666,667. However, the amount in excess of the $250,000 previously recognized would not be recorded until the IPO occurs.~~

Entry at date of issuance:

Cash	$1,000,000	
Debt discount ~~Interest expense~~	250,000	
Debt		$1,000,000
APIC		250,000

~~Subsequent entry (assuming IPO occurs):~~

~~Interest expense~~	~~$416,667~~	
~~APIC~~		~~$416,667~~

The terms of the convertible debt instrument do not permit the number of shares that would be received upon conversion if an IPO occurs to be calculated at the commitment date. Refer to Issues 3 and 7 of Issue 00-27 for guidance on recognition and measurement of the contingent beneficial conversion feature.

[18](1,000,000 ÷ 40) × (50 – 40)
~~[19](1,000,000 ÷ 30) × (50 – 30)~~

n. Exhibit 98-5A, Case 4:

Assumptions:

1. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance.
2. Convertible at date of issuance.
3. Convertible at 80 percent of stock price at commitment date (that is, $40).
4. FV of common at commitment date equals $50 per share.
5. If the stock price increases at least 15 percent one year after an IPO, the conversion feature adjusts to 65 percent of the fair value of the common stock one year after the IPO.

Calculation:

FV at commitment date	$50
Conversion price at commitment date	$40
Conversion price at contingency resolution	unknown~~$37.38~~[20]
Intrinsic value of basic beneficial conversion feature at commitment date	$250,000[21]
Intrinsic value of contingent beneficial conversion feature at commitment date	unknown~~$538,256~~[22]

The amount of the beneficial conversion feature is measured using the terms of the beneficial conversion feature that are operative at issuance, that is, the 20 percent discount. The intrinsic value of that beneficial conversion feature ($250,000) is calculated at the commitment date and recorded at the issuance date. Because the debt ~~is convertible at the date of issuance, the debt discount is charged to interest expense at the date of issuance.~~ has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.

~~Because this instrument also contains a contingent beneficial conversion feature, that amount also should be calculated at the commitment date assuming that an IPO will occur in the future and the company's stock appreciates by the requisite percentage using facts available at the commitment date. Accordingly, the conversion price is calculated assuming that (a) the IPO price is the stock price at the commitment date and (b) the targeted stock appreciation is achieved. However, an additional amount, representing the intrinsic value of the "contingent" beneficial conversion feature ($288,256),[23] would only be recorded once the IPO has been completed and the targeted stock price has been achieved 1 year later.~~

Entry at date of issuance:

Cash	$1,000,000	
Debt discount ~~Interest expense~~	250,000	
Debt		$1,000,000
APIC		250,000

~~Subsequent entry (assuming IPO occurs and targeted stock price is achieved):~~

~~Interest expense~~	~~$288,256~~	
~~APIC~~		~~$288,256~~

The terms of the convertible debt instrument do not permit the number of shares that would be received upon conversion if an IPO occurs to be calculated at the commitment date. Refer to Issues 3 and 7 of Issue 00-27 for guidance on recognition and measurement of the contingent beneficial conversion feature.

~~[20](50 x 115%) × 65%~~

[21](1,000,000 ÷ 40) × (50 – 40)

~~[22](1,000,000 ÷ 37.38) × (57.50 – 37.38)~~

~~[23]$538,256 – $250,000~~

o. Exhibit 98-5A, Case 6:

At the commitment date:

Proceeds from issuance of zero coupon convertible debt	$100
Intrinsic value of beneficial conversion feature	$90

At the commitment date, the issuer records $90 as discount on the debt with the offsetting entry to additional paid-in capital. The remainder ($10) is recorded as debt and is accreted to its full face value of $100 over the period from the issuance date until the stated redemption date of the instrument (3 years)~~earliest conversion date~~. The debt is subsequently extinguished one year after issuance.

At the extinguishment date:

Reacquisition price	$150
Intrinsic value of beneficial conversion feature at extinguishment date	$80
Carrying value of debt	$22[25]~~100~~

At the date of extinguishment, the extinguishment proceeds should first be allocated to the beneficial conversion feature ($80 as noted above). The remainder ($70) is allocated to the extinguishment of the convertible security.

Entry to record the extinguishment:

Debt	$22~~100~~	
Equity (paid-in capital)	80	
Loss on extinguishment	48	
~~Gain on extinguishment~~		~~$ 30~~
Cash		150

[25]The net carrying value of the debt one year after issuance is calculated using the effective interest method to amortize the debt discount over three years.

Appendix 98-5B

EITF ABSTRACTS **(DRAFT[*])**

Issue No. 08-4

Title: Transition Guidance for Conforming Changes to Issue No. 98-5

Dates Discussed: March 12, 2008; [June 11–12, 2008]

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

EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios"

EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments"

Objective

1. **The objective of this Issue is to provide transition guidance for conforming changes made to Issue 98-5 that result from Issue 00-27 and Statement 150.**

All paragraphs in this Issue have equal authority.
Paragraphs in bold set out the main principles.

Background

2. Certain consensuses in Issue 00-27 nullified portions of the guidance in Issue 98-5. A general status update that included transition guidance was added to Issue 98-5 to acknowledge the issuance of Issue 00-27. However, the portions of Issue 98-5 that were nullified by Issue 00-27 were not specifically identified in Issue 98-5, nor were the illustrative examples in Issue 98-5 updated for the effects of Issue 00-27.

3. In addition, Statement 150 was issued in May 2003. Instruments within the scope of Statement 150 are accounted for pursuant to the guidance in that Statement, not the guidance in Issues 98-5 and 00-27. A status update was added to Issue 00-27 clarifying that instruments within the scope of Statement 150 are no longer within the scope of Issue 00-27. However, a status update for Statement 150 was not included in Issue 98-5.

[*] **This draft abstract is being exposed for a public comment period that will end on May 5, 2008.**

Scope

4. **This issue applies to the conforming changes (included in Exhibit 08-4A) made to Issue 98-5 that result from Issue 00-27 and Statement 150.**

Transition

5. **Conforming changes made to Issue 98-5 that result from Issue 00-27 and Statement 150 shall be effective for financial statements issued for fiscal years ending after December 15, 2008. Early application is permitted. The impact of applying the conforming changes, if any, shall be presented retrospectively with the cumulative-effect of the change being reported in retained earnings in the statement of financial position as of the beginning of the first period presented.**

6. If as a result of applying the conforming changes in this Issue an entity has a change to its accounting, it shall comply with the disclosure requirements of Statement 154 for changes in accounting principles. Exhibit 08-4A includes the conforming changes made to Issue 98-5 relating to Issue 00-27 and Statement 150. [Added text is underlined and deleted text is ~~struck out~~.]

The provisions of this Issue need not be applied to immaterial items.

Exhibit 08-4A

EITF ABSTRACTS

Issue No. 98-5

Title: Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios

Dates Discussed: May 21, 1998; July 23, 1998; September 23–24, 1998; November 18–19, 1998; January 21, 1999; March 24–25, 1999; May 19–20, 1999; March 12, 2008

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

FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

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

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

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

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

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

FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

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

APB Opinion No. 20, *Accounting Changes*

APB Opinion No. 21, *Interest on Receivables and Payables*

APB Opinion No. 25, *Accounting for Stock Issued to Employees*

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*

AICPA Accounting Interpretation, *Interest on Receivables and Payables*, of APB Opinion No. 21

SEC Staff Accounting Bulletin No. 68, *Increasing Rate Preferred Stock*

EITF Issue No. 85-17, "Accrued Interest upon Conversion of Convertible Debt"

EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments"

EITF Issue No. 08-4, "Transition Guidance for Conforming Changes to Issue No. 98-5"

ISSUE

1. Entities may issue convertible debt securities and convertible preferred stock with a nondetachable conversion feature that is in-the-money at the commitment date[1] (a "beneficial conversion feature"). Those securities may be convertible into common stock at the lower of a conversion rate fixed at the commitment date or a fixed discount to the market price of the common stock at the date of conversion. Opinion 14 addresses an issuer's accounting for convertible debt with a nondetachable (embedded) conversion feature, the terms of which provide for (a) an initial conversion price that is greater than market value at the date of issuance and (b) a conversion price that does not decrease, except under antidilution protection. Opinion 14 does not explicitly address situations in which the embedded conversion feature is in-the-money at issuance, nor does it explicitly address convertible preferred stock.

2. Certain convertible securities may have a conversion price that is variable based on future events such as a subsequent round of financing at a price lower than the convertible securities' original conversion price, a liquidation or a change in control of the company, or an initial public offering at a share price lower than an agreed-upon amount. Opinion 14 also does not explicitly

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[1] ~~The commitment date is the date when an agreement as to terms has been reached and the investor is committed to purchase the convertible securities based on those terms (that is, performance by the investor is probable because of sufficiently large disincentives for nonperformance). In certain cases, the securities may be purchased by a number of investors, such as a group of lenders participating in a syndicate. In those situations, the latest commitment date for the group or issuance date for each individual security, whichever comes first, should be considered the commitment date.~~ The commitment date is defined as the date when an agreement has been reached 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.

The Task Force observed that if an agreement includes subjective provisions that permit either party to rescind its commitment to consummate the transaction (for example, a provision that allows an investor to rescind its commitment to purchase a convertible instrument in the event of a material adverse change in the issuer's operations or financial condition or a provision that makes the commitment subject to customary due diligence or shareholder approval), a commitment date should not occur until the provisions expire or the convertible instrument is issued, whichever is earlier. [Note: This consensus has been modified by Issue 4 of Issue 00-27. See paragraphs 17A – 18C of the STATUS section.]

address situations in which the conversion terms are contingently adjustable.

3. This Issue applies to convertible securities with beneficial conversion features that must be settled in stock and to those that give the issuer a choice of settling the obligation in either stock or cash. This Issue also applies to instruments with beneficial conversion features that are convertible into multiple instruments, for example, a convertible preferred stock that is convertible into common stock and detachable warrants. In addition, this Issue applies to instruments with conversion features that are not beneficial at the commitment date but that become beneficial upon the occurrence of a future event, such as an initial public offering.

4. The issues are:

Issue 1—Whether embedded beneficial conversion features present in convertible securities should be valued separately at the commitment date

Issue 2—If the answer to Issue 1 is to value beneficial conversion features separately, then how an embedded conversion feature should be recognized and measured

Issue 3—How the issuance of convertible securities with beneficial conversion ratios that adjust (or arise) based on the occurrence of specified future events should be accounted for.

EITF DISCUSSION

5. The Task Force reached a consensus that embedded beneficial conversion features present in convertible securities should be valued separately at issuance. [Note: This consensus has been partially nullified by Statement 133 and Statement 150. See STATUS section.] The embedded beneficial conversion feature should be recognized and measured by allocating a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. That amount should be calculated at the commitment date[2] as the difference between the conversion price and the fair value[3] 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 (intrinsic value).[4]

6. The Task Force observed that in certain circumstances, the intrinsic value of the beneficial

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[2]Refer to footnote 1.

[3]The fair value is the amount at which the common stock and/or other securities could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. That quoted price should not be adjusted to reflect transferability restrictions, large block factors, avoided underwriter's fees, or time value discounts. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances.

[4]In circumstances in which convertible securities are issued with detachable warrants, the Task Force noted that in order to determine the amount to be allocated to the beneficial conversion feature, the issuer must first allocate the proceeds between the convertible instrument and the detachable warrants using the relative fair value method of Opinion 14. A similar methodology would be used in circumstances in which convertible securities are issued along with another security, such as common stock.

conversion feature may be greater than the proceeds allocated to the convertible instrument. In those situations, the Task Force reached a consensus that the amount of the discount assigned to the beneficial conversion feature is limited to the amount of the proceeds allocated to the convertible instrument. [Note: This consensus has been partially nullified by Statement 133. See STATUS section.] ~~Except as provided in paragraph 10 below, the discount assigned to the convertible instrument, if any, should be amortized over the period to the security's earliest conversion date.~~ For convertible instruments that have a stated redemption date, a discount resulting from recording a beneficial conversion option shall be required to be amortized from the date of issuance to the stated redemption date of the convertible instrument, regardless of when the earliest conversion date occurs. For convertible instruments that do **not** have a stated redemption date, such as perpetual preferred stock, a discount resulting from the accounting for a beneficial conversion option shall be amortized from the date of issuance to the earliest conversion date. [Note: This consensus has been amended by Issue 6 of Issue 00-27. See paragraphs 17A – 18C of the STATUS section.]

7. The Task Force noted that, in accordance with Statement 129, the issuer should disclose in the footnotes to its financial statements the terms of the transaction, including the excess of the aggregate fair value of the instruments that the holder would receive at conversion over the proceeds received and the period over which the discount is amortized.

8. For convertible preferred securities, any recorded discount resulting from allocation of proceeds to the beneficial conversion feature is analogous to a dividend and should be recognized as a return to the preferred shareholders~~ over the minimum period from the date of issuance to the date at which the preferred shareholders can realize that return (that is, through the date of earliest conversion)~~[5] using the effective yield method. [Note: This consensus has been amended by Issue 6 of Issue 00-27. See paragraphs 17A – 18C of the STATUS section.]

9. For convertible debt securities, any recorded discount resulting from allocation of proceeds to the beneficial conversion feature should be recognized as interest expense~~ over the minimum period from the date of issuance to the date at which the debtholder can realize that return (that is, through the date of earliest conversion~~[6]~~)~~ using the effective yield method. [Note: This consensus has been amended by Issue 6 of Issue 00-27. See paragraphs 17A – 18C of the STATUS section.]

10. In situations in which the instrument incorporates a multiple-step discount (for example, an instrument that provides for a 15 percent discount to the market price after 3 months, a 25 percent discount after 6 months, a 35 percent discount after 9 months, and a 40 percent discount after 1 year), the basic accounting model described above is modified. For those types of convertible securities, the Task Force reached a consensus that the computation of the intrinsic value should be made using the conversion terms that are most beneficial to the investor. If the convertible instrument has a stated redemption date, the resultant discount should be amortized from the date of issuance to the stated redemption date of the convertible instrument, regardless

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[5] ~~For those preferred securities that are convertible at the date of issuance, the Task Force observed that the discount would be fully amortized through retained earnings at the date of issuance.~~

[6] ~~For those debt securities that are convertible at the date of issuance, the Task Force observed that the discount would be fully amortized through interest expense at the date of issuance.~~

of when the earliest conversion date occurs (in the example noted above, the discount would be 40 percent and the amortization period would be from issuance to the stated redemption date). [Note: This consensus has been amended by Issue 6 of Issue 00-27. See paragraphs 17A – 18C of the STATUS section.]

10A. ~~The resultant discount should be~~For convertible instruments that do **not** have a stated redemption date, the resultant discount should be amortized over the minimum period in which the investor can recognize that return (in the example noted above, the discount would be 40 percent and the amortization period would be 1 year). [Note: This consensus has been amended by Issue 6 of Issue 00-27. See paragraphs 17A – 18C of the STATUS section.] However, amortization recognized may require adjustment to ensure that the discount amortized at any point in time is not less than the amount the holder of the instrument could obtain if conversion occurred at that date. That is, at the end of 3 months, at least the 15 percent discount should have been recognized. This method can be expressed as requiring cumulative amortization equal to the *greater of* (a) the amount derived using the effective yield method based on the conversion terms most beneficial to the investor or (b) the amount of discount which the investor can realize at that interim date.

11. In circumstances in which the instrument is converted prior to amortization of the full amount of the discount, the remaining unamortized discount at the date of conversion should be ~~included in the carrying value of the convertible security that is transferred to equity at the date of conversion.~~ immediately recognized as interest expense or as a dividend, as appropriate.[6a] If the amount of unamortized discount is recognized as an expense (because the convertible instrument was in debt form), the expense should not be classified as extraordinary. [Note: This consensus has been amended by Issue 6 of Issue 00-27. See paragraphs 17A – 18C of the STATUS section.] If, however, the amount of discount amortized exceeds the amount the holder realized because conversion occurred at an earlier date, the Task Force agreed that no adjustment should be made to amounts previously amortized.

12. The Task Force also considered situations in which a debt instrument containing the embedded beneficial conversion feature is extinguished prior to conversion. The Task Force recognized that a portion of the reacquisition price includes a repurchase of the beneficial conversion feature. The Task Force reached a consensus that the amount of the reacquisition price to be allocated to the beneficial conversion feature should be measured using the intrinsic value of that conversion feature at the extinguishment date. The residual amount, if any, would be allocated to the convertible security. The Task Force indicated that the issuer would record a gain or loss on extinguishment of the convertible debt security. The Task Force observed that the gain or loss from the extinguishment of debt should be classified in accordance with the guidance in Statement 4. [Note: See STATUS section.] If the convertible instrument is a preferred security, guidance is provided in Topics No. D-42, "The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock," and No. D-53, "Computation of Earnings per Share for a Period That Includes a Redemption or an Induced Conversion of a Portion of a Class of Preferred Stock."

[6a] For convertible debt that does not include a beneficial conversion option, Accounting Interpretation 1 of Opinion 26 and Issue 85-17 continue to apply. Those pronouncements state that the net carrying amount of the convertible debt, including any unamortized premium or discount, is credited to equity upon conversion.

13. The Task Force also discussed the accounting for (a) a security that becomes convertible only upon the occurrence of a future event outside the control of the holder and (b) a security that is convertible from inception but contains conversion terms that change upon the occurrence of a future event. The Task Force reached a consensus that any contingent beneficial conversion feature should be measured ~~at~~ using the commitment date stock price but not recognized in earnings until the contingency is resolved.

14. The consensuses reached are applicable to instruments issued after May 20, 1999. Examples of the application of the above consensuses are in Exhibit 98-5A.

14A. Conforming changes made to Issue 98-5 relating to Issue 00-27 and Statement 150 shall be effective for financial statements issued for fiscal years ending after December 15, 2008, with early application permitted.[6b] The impact of applying the conforming changes, if any, should be presented retrospectively with the cumulative-effect of the change being reported in retained earnings in the statement of financial position as of the beginning of the first period presented. [Note: See paragraphs 17A – 18C and 19A – 19C of the STATUS section.]

STATUS

15. Statement 133 was issued in June 1998 and has been subsequently amended. The effective date for Statement 133, as amended, is for all fiscal quarters of all fiscal years beginning after June 15, 2000.

16. The terms of the entire embedded conversion feature should be analyzed to determine whether it meets the criteria under paragraph 12 of Statement 133 to be separated from the host contract and accounted for as a derivative under that Statement. Paragraph 12(c) indicates that one criterion for separate accounting essentially is that the embedded derivative, as a freestanding instrument, would meet the definition of a derivative and be subject to Statement 133. Under paragraph 11(a) of Statement 133, contracts issued by the reporting entity that are both (1) indexed only to its own stock and (2) classified in stockholders' equity in its statement of financial position are not considered derivatives by that entity under Statement 133. However, the scope exception in paragraph 11(a) does not apply to the holder of a security convertible into the common stock of the issuer. Furthermore, the holder generally will conclude that the embedded conversion feature is not clearly and closely related to the host contract (refer to the criterion in paragraph 12(a)). Statement 155, which was issued in February 2006, amends Statement 133. Statement 155 provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. A hybrid financial instrument that is elected to be accounted for in its entirety at fair value cannot be used as a hedging instrument in a Statement 133 hedging relationship.

17. During the discussion of this Issue, it was mentioned that the issuer of those securities will generally be unable to reliably measure the fair value of the embedded beneficial conversion

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[6b] Conforming changes were made to the following portions of Issue 98-5: footnote 1 to paragraph 1; paragraph 6; paragraph 8 and its related footnote 5; paragraph 9 and its related footnote 6; paragraphs 10, 10A, 11, 13, 17A, 18, 18B, 18C, 19A, 19B, and 19C; Cases 1(a), 1(b), 1(c), 1(d), 2, 3, 4, 5 and 6.

feature. The observation may be equally applicable to the holder of such securities. Paragraph 16 of Statement 133 states, "If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement." However, paragraph 301 of Statement 133 clarifies that it should be unusual that an entity would conclude that it cannot reliably separate an embedded derivative from its host contract.

17A. Issue 00-27 addresses a number of practice issues raised about the application of the Issue 98-5 model. The Task Force reached consensuses on portions of Issue 00-27 at the November 15–16, 2000 meeting.

18. The original consensuses reached in Issue 98-5 are applicable to instruments issued after May 20, 1999 and prior to November 16, 2000 (unless a commitment date, as defined under Issue 98-5, occurred before November 16, 2000, in which case Issue 98-5 applies to those instruments). For instruments issued after November 16, 2000, for which a commitment date, as originally defined in Issue 98-5, has not occurred prior to November 16, 2000, the consensuses in Issue ~~No.~~ 00-27~~, "Application of Issue No. 98-5 to Certain Convertible Instruments,"~~ should be applied. Issue 98-5 originally defined a commitment date as the date when an agreement as to terms has been reached and the investor is committed to purchase the convertible securities based on those terms (that is, performance by the investor is probable because of sufficiently large disincentives for nonperformance). In certain cases, the securities may be purchased by a number of investors, such as a group of lenders participating in a syndicate. In those cases, the latest commitment date for the group or issuance date for each individual security, whichever comes first, should be considered as the commitment date.

18A. During the discussions of Issue 00-27, the SEC Observer stated that the consensus on Issue 1 of Part II of Issue 00-27 must be applied to all transactions subject to Issue 98-5, including those transactions for which a commitment date occurred before November 16, 2000. The effect, if any, of initial application of the consensus on Issue 1 of Part II to all prior transactions (including existing, terminated, and converted) subject to Issue 98-5 should be reported as of the beginning of a registrant's quarter that includes the date of the Issue 00-27 consensus (November 16, 2000) in a manner similar to the cumulative effect of a change in accounting principle in accordance with Opinion 20.

18B. Cases 1(a), 1(b), 2, 3, 4, and 6 in Exhibit 98-5A have been amended to reflect the guidance provided in Issue 00-27.

18C. Refer to Exhibit 00-27B of Issue 00-27 for an illustration of the amendments to Issue 98-5 by Issue 00-27.

19. 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.

19A. Statement 150 was issued in May 2003 and 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, 2004, except for mandatorily redeemable financial instruments of a nonpublic entity. Statement 150 establishes standards for issuer's classification and measurement of certain financial instruments with characteristics of both liabilities and equity, and requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances).

19B. Cases 1(c) and 5 in Exhibit 98-5A have been nullified as the instruments described in those examples are within the scope of Statement 150.

19C. At the March 12, 2008 meeting, the Task Force decided that Case 1(d) should be nullified as the instruments described in that example require an assessment of accounting literature that was issued subsequent to this Issue.

20. No further EITF discussion is planned.

Exhibit 98-5A

EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUSES ON ISSUE 98-5

Case 1(a)—Instrument Is Convertible at Inception, Fixed Dollar Conversion Terms (Base Case)

Assumptions:

1. $1,000,000 of convertible debt <u>with a redemption date on the fifth anniversary of issuance</u>.
2. Convertible at date of issuance.
3. Convertible at $40 per share.
4. Fair value (FV) of common at commitment date equals $50 per share.

Calculation:

FV at commitment date	$50
Conversion price (stated and will not change)	$40
Intrinsic value of beneficial conversion feature	$250,000[7]
Amount to record at date of issuance	**$250,000**

The beneficial conversion feature is calculated at its intrinsic value (that is, the difference between the conversion price and the fair value of the common stock into which the debt is convertible, multiplied by the number of shares into which the debt is convertible) at the commitment date. A portion of the proceeds from issuance of the convertible debt, equal to the intrinsic value, is then allocated to additional paid-in capital (APIC). Because the debt ~~is convertible at the date of issuance, the debt discount is charged to interest expense at the date of issuance.~~ <u>has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.</u>

Entry at date of issuance:

Cash	$1,000,000	
<u>Debt discount</u>~~Interest expense~~	250,000	
Debt		$1,000,000
APIC		250,000

<u>[Note: This example has been amended by Issue 6 of Issue 00-27. See paragraphs 17A – 18C of the STATUS section.]</u>

[7]Convertible into 25,000 shares (1,000,000 ÷ 40) with an intrinsic value of $10 (50 – 40) or overall: (1,000,000 ÷ 40) × (50 – 40).

Case 1(b)—Instrument Is *Not* Convertible at Inception, Fixed Dollar Conversion Terms (Base Case)

Assumptions:

1. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance.
2. Convertible in one year.
3. Convertible at $40 per share.
4. FV of common at commitment date equals $50 per share.

Calculation:

FV at commitment date	$50
Conversion price (stated and will not change)	$40
Intrinsic value of beneficial conversion feature	$250,000[8]
Amount to record over period to convert	**$250,000**

The beneficial conversion feature is calculated at its intrinsic value at the commitment date (that is, the difference between the conversion price and the fair value of the common stock into which the debt is convertible, multiplied by the number of shares into which the debt is convertible). A portion of the proceeds from issuance of the convertible debt, equal to the intrinsic value, is then allocated to additional paid-in capital. Because the debt ~~is convertible in one year, the debt discount is amortized to interest expense over one year using the interest method.~~ has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.

Entry at date of issuance:

Cash	$1,000,000	
Debt discount	250,000	
Debt		$1,000,000
APIC		250,000

[Note: This example has been amended by Issue 6 of Issue 00-27. See paragraphs 17A – 18C of the STATUS section.]

[8] (1,000,000 ÷ 40) × (50 – 40)

~~Case 1(c)—Instrument Is Convertible at Inception, Fixed Percentage Conversion Terms (Base Case)~~

~~Assumptions:~~

1. ~~$1,000,000 of convertible debt.~~
2. ~~Convertible at date of issuance.~~
3. ~~Convertible at 80 percent of fair market value when converted.~~
4. ~~FV of common at commitment date equals $50 per share.~~

~~Calculation~~:

~~FV at commitment date~~	~~$50~~
~~Conversion price~~	~~$40~~[9]
~~Intrinsic value of beneficial conversion feature~~	~~$250,000~~[10]

~~Amount to record at issuance~~	**~~$250,000~~**

~~In this case, the terms of the security change upon the occurrence of a future event (that is, the conversion price changes depending on the fair value of the common stock at the date of conversion). In this example, because the conversion percentage is fixed, the amount the investor will receive is *always* $250,000. However, because the beneficial conversion feature is to be settled by issuing equity, the amount attributed to the beneficial conversion feature is recorded as a component of equity. Because the debt is convertible at the date of issuance, the debt discount is charged to interest expense at the date of issuance.~~

~~Entry at date of issuance:~~

~~Cash~~	~~$1,000,000~~	
~~Interest expense~~	~~250,000~~	
~~Debt~~		~~$1,000,000~~
~~APIC~~		~~250,000~~

[9] ~~50 × 80%~~

[10] ~~(1,000,000 ÷ 40) × (50 – 40)~~

~~Case 1(d)—Instrument Is Convertible at Inception, Conversion Terms Are Not Fixed~~

~~Assumptions:~~

1. ~~$1,000,000 of convertible debt.~~
2. ~~Convertible at date of issuance.~~
3. ~~Convertible at the lower of 80 percent of fair market value when converted or $40.~~
4. ~~FV of common at commitment date equals $50 per share.~~

~~Calculation:~~

~~FV at conversion date~~	**~~$40~~**	**~~$50~~**	**~~$60~~**	**~~$70~~**
~~80% of stock price at conversion date~~	~~$32~~	~~$40~~	~~$48~~	~~$56~~
~~Conversion price~~	~~$32~~	~~$40~~	~~$40~~	~~$40~~
~~Intrinsic value of beneficial conversion feature at commitment date~~	~~$250,000~~[11]	~~$250,000~~[12]	~~$250,000~~[13]	~~$250,000~~[14]

~~The beneficial conversion feature is calculated at its intrinsic value at the commitment date (that is, the difference between the conversion price and the fair value of the common stock into which the debt is convertible, multiplied by the number of shares into which the debt is convertible). A portion of the proceeds from issuance of the convertible debt, equal to the intrinsic value of $250,000, is then allocated to additional paid-in capital. Because the debt is convertible at issuance, the debt discount is recorded as a charge to interest expense immediately. No additional amount would be recognized at the conversion date in recognition of an increase in the fair value of the stock conversion.~~

~~Entry at date of issuance:~~

~~Cash~~	~~$1,000,000~~	
~~Interest expense~~	~~250,000~~	
~~Debt~~		~~$1,000,000~~
~~APIC~~		~~250,000~~

[11] ~~(1,000,000 ÷ 40) × (50 – 40)~~

[12] ~~(1,000,000 ÷ 40) × (50 – 40)~~

[13] ~~(1,000,000 ÷ 40) × (50 – 40)~~

[14] ~~(1,000,000 ÷ 40) × (50 – 40)~~

Case 2—Instrument Containing a Fixed Percentage Conversion Feature Dependent on a Future Event

Assumptions:

1. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance.
2. Convertible upon an initial public offering (IPO).
3. Convertible at 80 percent of stock price at commitment date (that is, $40).
4. FV of common at commitment date equals $50 per share.

Calculation:

IPO price	**$50**	**$60**	**$70**
Stock price at commitment date	$50	$50	$50
80% of stock price at commitment date	$40	$40	$40
Intrinsic value of beneficial conversion feature at commitment date	$250,000[15]	$250,000[16]	$250,000[17]

The instrument is not convertible at the commitment date; however, it will become convertible and that conversion feature will be beneficial if an IPO is completed. The intrinsic value of the beneficial conversion feature is calculated at the commitment date using the stock price as of that date, that is, $250,000. However, that amount would only be recorded at the date an IPO is completed. If the IPO were completed on the third anniversary of the debt issuance, the discount amount would be recorded at that date and amortized over a two-year period ending on the stated redemption date of the debt.

Entry at issuance:

Cash	$1,000,000	
Debt		$1,000,000

Entry at IPO:

Debt discount ~~Interest expense~~	$250,000	
APIC		$250,000

[Note: This example has been amended by Issue 6 of Issue 00-27. See paragraphs 17A – 18C of the STATUS section.]

[15] $(1,000,000 \div 40) \times (50 – 40)$

[16] $(1,000,000 \div 40) \times (50 – 40)$

[17] $(1,000,000 \div 40) \times (50 – 40)$

Case 3—Convertible Instrument Containing Fixed Terms That Change Based on a Future Event

Assumptions:

1. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance.
2. Convertible at date of issuance.
3. Convertible at 80 percent of stock price at commitment date (that is, $40).
4. FV of common at commitment date equals $50 per share.
5. If there is an IPO, the conversion feature adjusts to the lesser of $30 or 80 percent of the IPO price.

Calculation:

FV at commitment date	$50
Conversion price at commitment date	$40
Intrinsic value of basic beneficial conversion feature at commitment date	$250,000[18]
Conversion price at contingency resolution	unknown
~~Most beneficial conversion price at commitment date~~	~~$30~~
Intrinsic value of contingent beneficial conversion feature at commitment date	unknown~~$666,667[19]~~
~~Amount recorded at issuance date~~	~~250,000~~
~~Additional intrinsic value of contingent beneficial conversion feature at commitment date~~	~~$416,667~~

This instrument includes a "basic" beneficial conversion feature that is not contingent upon the occurrence of a future event and a contingent beneficial conversion feature. Accordingly, the intrinsic value of the basic beneficial conversion feature of $250,000 is calculated at the commitment date and recorded at the issuance date. Because the debt ~~is convertible at the date of issuance, the debt discount is charged to interest expense at the date of issuance.~~ has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.

~~The amount of the contingent beneficial conversion feature also is calculated at the commitment date using the terms most advantageous to the investor, based on the facts available at that date. In this instance, the most beneficial conversion price at the commitment date is $30 per share. Accordingly, the beneficial conversion feature is calculated using the $30 per-share conversion price resulting in a contingent beneficial conversion amount of $666,667. However, the amount in excess of the $250,000 previously recognized would not be recorded until the IPO occurs.~~

[18] (1,000,000 ÷ 40) × (50 – 40)

[19] ~~(1,000,000 ÷ 30) × (50 – 30)~~

Entry at date of issuance:

Cash	$1,000,000	
Debt discount ~~Interest expense~~	250,000	
Debt		$1,000,000
APIC		250,000

~~Subsequent entry (assuming IPO occurs):~~

~~Interest expense~~	~~$416,667~~	
~~APIC~~		~~$416,667~~

The terms of the convertible debt instrument do not permit the number of shares that would be received upon conversion if an IPO occurs to be calculated at the commitment date. Refer to Issues 3 and 7 of Issue 00-27 for guidance on recognition and measurement of the contingent beneficial conversion feature.

[Note: This example has been amended by Issue 6 of Issue 00-27. See paragraphs 17A – 18C of the STATUS section.]

Case 4—Conversion Dependent on a Future Event and Terms Are Variable

Assumptions:

1. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance.
2. Convertible at date of issuance.
3. Convertible at 80 percent of stock price at commitment date (that is, $40).
4. FV of common at commitment date equals $50 per share.
5. If the stock price increases at least 15 percent one year after an IPO, the conversion feature adjusts to 65 percent of the fair value of the common stock one year after the IPO.

Calculation:

FV at commitment date	$50
Conversion price at commitment date	$40
Conversion price at contingency resolution	unknown~~$37.38~~[~~20~~]
Intrinsic value of basic beneficial conversion feature at commitment date	$250,000[21]
Intrinsic value of contingent beneficial conversion feature at commitment date	unknown~~$538,256~~[~~22~~]

[20]~~(50 × 115%) × 65%~~

[21](1,000,000 ÷ 40) × (50 – 40)

[22]~~(1,000,000 ÷ 37.38) × (57.50 – 37.38)~~

The amount of the beneficial conversion feature is measured using the terms of the beneficial conversion feature that are operative at issuance, that is, the 20 percent discount. The intrinsic value of that beneficial conversion feature ($250,000) is calculated at the commitment date and recorded at the issuance date. Because the debt ~~is convertible at the date of issuance, the debt discount is charged to interest expense at the date of issuance~~ has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.

~~Because this instrument also contains a contingent beneficial conversion feature, that amount also should be calculated at the commitment date assuming that an IPO will occur in the future and the company's stock appreciates by the requisite percentage using facts available at the commitment date. Accordingly, the conversion price is calculated assuming that (a) the IPO price is the stock price at the commitment date and (b) the targeted stock appreciation is achieved. However, an additional amount, representing the intrinsic value of the "contingent" beneficial conversion feature ($288,256),[23] would only be recorded once the IPO has been completed and the targeted stock price has been achieved 1 year later.~~

Entry at date of issuance:

Cash	$1,000,000	
Debt discount ~~Interest expense~~	250,000	
Debt		$1,000,000
APIC		250,000

~~Subsequent entry (assuming IPO occurs and targeted stock price is achieved):~~

~~Interest expense~~	~~$288,256~~	
~~APIC~~		~~$288,256~~

The terms of the convertible debt instrument do not permit the number of shares that would be received upon conversion if an IPO occurs to be calculated at the commitment date. Refer to Issues 3 and 7 of Issue 00-27 for guidance on recognition and measurement of the contingent beneficial conversion feature.

[Note: This example has been amended by Issue 6 of Issue 00-27. See paragraphs 17A – 18C of the STATUS section.]

~~Case 5—Fixed Percentage Conversion Price Based on a Range of Stock Prices in the Future~~

~~Assumptions:~~

~~1. $1,000,000 of convertible debt.~~
~~2. Convertible at date of issuance.~~

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[23] ~~$538,256 – $250,000~~

3. ~~Convertible at 80 percent of the average stock price for the 30 days preceding the date of conversion.~~
4. ~~FVof common at commitment date equals $50 per share.~~
5. ~~Average price per share for the 30 days preceding the commitment date equals $45 per share.~~

~~**Calculation:**~~

~~FV at commitment date~~	~~$50~~
~~80% of range preceding date of issuance~~	~~$36~~
~~Intrinsic value of beneficial conversion feature at commitment date~~	~~$388,889~~[24]

~~The intrinsic value of the beneficial conversion feature is measured at the commitment date using facts available at that date. In this instance, the average stock price for the 30-day period preceding the commitment date is used in calculating the beneficial conversion feature. Because the security is immediately convertible, the intrinsic value of the beneficial conversion feature ($388,889) would be charged to interest expense at issuance.~~

~~Entry at date of issuance:~~

~~Cash~~	~~$1,000,000~~	
~~Interest expense~~	~~388,889~~	
~~Debt~~		~~$1,000,000~~
~~APIC~~		~~388,889~~

Case 6—Extinguishment of Convertible Debt That Includes a Beneficial Conversion Feature

At the commitment date:

Proceeds from issuance of zero coupon convertible debt	$100
Intrinsic value of beneficial conversion feature	$90

At the commitment date, the issuer records $90 as discount on the debt with the offsetting entry to additional paid-in capital. The remainder ($10) is recorded as debt and is accreted to its full face value of $100 over the period from the issuance date until the stated redemption date of the instrument (3 years)~~earliest conversion date~~. The debt is subsequently extinguished one year after issuance.

[24](1,000,000 ÷ 36) × (50 – 36)

At the extinguishment date:

Reacquisition price	$150
Intrinsic value of beneficial conversion feature at extinguishment date	$80
Carrying value of debt	$22[25] ~~100~~

At the date of extinguishment, the extinguishment proceeds should first be allocated to the beneficial conversion feature ($80 as noted above). The remainder ($70) is allocated to the extinguishment of the convertible security.

Entry to record the extinguishment:

Debt	$22~~100~~	
Equity (paid-in capital)	80	
Loss on extinguishment	48	
~~Gain on extinguishment~~		~~$30~~
Cash		150

[Note: This example has been amended by Issue 6 of Issue 00-27. See paragraphs 17A – 18C of the STATUS section.]

[25] The net carrying value of the debt one year after issuance is calculated using the effective interest method to amortize the debt discount over three years.

Issue No. 07-4

Title: Application of the Two-Class Method under FASB Statement No. 128, *Earnings per Share*, to Master Limited Partnerships

Dates Discussed: June 14, 2007; September 11, 2007; November 29, 2007; March 12, 2008

References: FASB Statement No. 128, *Earnings per Share*

AICPA Statement of Position 95-2, *Financial Reporting by Nonpublic Investment Partnerships*

International Accounting Standard 33, *Earnings per Share*

EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128"

EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share"

EITF Abstracts, Topic No. D-72, "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share"

EITF Abstracts, Topic No. D-82, "Effect of Preferred Stock Dividends Payable in Common Shares on Computation of Income Available to Common Stockholders"

Introduction

1. Publicly traded master limited partnerships (MLPs) often issue multiple classes of securities that may participate in partnership distributions according to a formula specified in the partnership agreement. A typical MLP consists of publicly-traded common units held by limited partners (LPs), a general partner (GP) interest, and incentive distribution rights (IDRs). Depending on the structure of the MLP, the IDRs may be a separate class of non-voting limited partner interest that the GP initially holds but generally may transfer or sell apart from its overall interest. Alternatively, the IDRs may be embedded in the GP interest such that they cannot be detached and transferred apart from the GP's overall interest.

2. Generally, the partnership agreement obligates the GP to distribute 100 percent of the partnership's available cash[1] at the end of each quarter to the GP and LPs via a distribution waterfall (that is, a schedule that prescribes distributions to the GP and LPs at each threshold). When certain thresholds are met, the distribution waterfall further allocates available cash to the holder of the separate class of non-voting limited partner interest (the IDR holder) or, when the IDR is embedded in the GP interest, to the GP. The net income (or loss) of the partnership is allocated to the capital accounts of the GP and LPs based on their respective sharing of income

[1] Available cash is typically defined in the partnership agreement as all cash on hand at the end of each quarter less cash retained by the partnership as capital to (a) operate the business (for example, future capital expenditures), (b) comply with applicable law, debt, and other agreements, and (c) provide funds for distribution to the common units, GP, and IDR holders for any one or more of the next four quarters.

or losses specified in the partnership agreement, but only after taking into account any priority income allocations resulting from incentive distributions.

3. As a result of the capital structure of MLPs, the partnership is required to apply the two-class method of computing earnings per unit (EPU). Paragraph 61 of Statement 128 describes the two-class method as an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Undistributed earnings are allocated to the common unit(s) and participating securities as if all earnings for the period had been distributed. When applying the two-class method to the interests of the GP and LPs in an MLP, questions have been raised about the impact of IDRs on the computation of EPU.

Scope

4. This Issue applies to MLPs that are required to make incentive distributions when certain thresholds have been met regardless of whether the IDR is a separate LP interest or embedded in the GP interest. This Issue only addresses incentive distributions that are treated as equity distributions and does not address whether the incentive distributions are compensation or equity distributions.

Prior EITF Discussion

5. The original issue brought to the Task Force at the June 14, 2007 EITF meeting was as follows:

Issue 1— When applying the two-class method under Statement 128, how current period earnings of an MLP should be allocated to the GP, LPs, and, when applicable, IDRs.

6. The Task Force discussed this Issue but was not asked to reach a conclusion. The Task Force requested that the FASB staff provide additional examples illustrating the application of the various alternatives for discussion at a future EITF meeting. In addition, the Task Force requested that the FASB staff obtain additional information about IDRs and the nature of the GP's involvement with the MLP.

7. At the September 11, 2007 EITF meeting, the Task Force discussed how current-period earnings of an MLP should be allocated to the GP and LPs when the arrangement includes IDRs. The Task Force observed that the determination of whether the incentive distribution is an equity distribution or compensation expense is outside the scope of this Issue. Accordingly, the Task Force reached a consensus-for-exposure that this Issue applies only to MLPs that have concluded that the incentive distribution is an equity distribution.

8. The Task Force also reached a consensus-for-exposure that this Issue applies to all MLP arrangements regardless of whether the IDRs are a separate interest or embedded in the GP interest. That is, when the IDRs are a separate interest, the IDRs represent a participating security and therefore the MLP would allocate current-period earnings to the GP, LP, and IDR holder using the two-class method. In contrast, when the IDR is embedded in the GP interest, the IDR would not be considered a participating security; however, the MLP would still apply the two-class method to the interests of the GP and LPs. In those circumstances, the GP's

earnings allocation would include the rights of the IDR. The Task Force recommended that the Notice for Recipients in the draft abstract specifically request input from constituents on whether they agree that the scope of this Issue includes IDRs that are embedded in the GP interest.

9. The Task Force reached a consensus-for-exposure that when current-period earnings are in excess of cash distributions and the IDRs are a separate LP interest, undistributed earnings should be allocated to the GP, LPs, and IDR holder as if the undistributed earnings were available cash. That is, undistributed earnings would be allocated to the GP, LPs, and IDR holder utilizing the distribution formula for available cash specified in the partnership agreement. Similarly, when the IDR is embedded in the GP interest, undistributed earnings should be allocated to the GP (including the distribution rights of the embedded IDR) and LPs as if the undistributed earnings were available cash. In reaching its consensus-for-exposure, the Task Force observed that the distribution formula based on available cash would not be considered a "specified threshold" as described in Example F in paragraph 16 of Issue 03-6.

10. The Task Force also reached a consensus-for-exposure that when cash distributions are in excess of current-period earnings and the IDRs are a separate LP interest, net income (or loss) should be reduced (or increased) by distributions to the GP, LPs, and IDR holder. The resulting excess of distributions over earnings would be allocated to the GP and LPs based on their respective sharing of losses (that is, the provisions for allocation of losses to the partners' capital accounts) specified in the partnership agreement. This consensus-for-exposure assumes that the IDR holder does not have a contractual obligation to share in the losses of the MLP (as described in paragraphs 17 and 18 of Issue 03-6). If the IDR holder has a contractual obligation to share in the losses of the MLP on an objectively determined basis, the excess of distributions over earnings would be allocated to the GP, LPs, and IDR holder based on their respective sharing of losses specified in the partnership agreement. Similarly, when the IDR is embedded in the GP interest, net income (or loss) should be reduced (or increased) by distributions to the GP (including the distribution rights of the embedded IDR) and LPs. The resulting excess of distributions over earnings would be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement.

11. At the November 29, 2007 EITF meeting, the Task Force discussed the informal comments received on the draft abstract. The Task Force decided to change its previous consensus-for-exposure reached at the September 11, 2007 EITF meeting on how to allocate current-period earnings to the GP, LPs, and IDR holder when current-period earnings exceed cash distributions.

12. The Task Force reached a consensus-for-exposure that when current-period earnings are in excess of cash distributions and the IDRs are a separate LP interest, undistributed earnings should be allocated to the GP, LPs, and IDR holder utilizing the contractual terms of the partnership agreement. The distribution formula for available cash specified in the partnership agreement contractually mandates the way in which earnings are distributed. Similarly, when the IDR is embedded in the GP interest, undistributed earnings should be allocated to the GP (including the distribution rights of the embedded IDR) and LPs utilizing the distribution formula for available cash specified in the partnership agreement. The undistributed earnings should be allocated to the IDR holder (or the GP with respect to the distribution rights of an embedded IDR) based on the contractual participation rights of the IDR to share in current

period earnings. Therefore, if the partnership agreement includes a "specified threshold" as described in Example F in paragraph 16 of Issue 03-6, an MLP should not allocate undistributed earnings to the IDR holder (or the GP with respect to the distribution rights of an embedded IDR) once the specified threshold has been met. In determining whether a specified threshold exists, an MLP should evaluate whether distributions to the IDR holder (or the GP with respect to the distribution rights of an embedded IDR) would be contractually limited to available cash as defined in the partnership agreement. If distributions to the IDR holder (or the GP with respect to the distribution rights of an embedded IDR) would be contractually limited to available cash as defined in the partnership agreement, then the MLP would not allocate undistributed earnings to the IDR holder (or the GP with respect to the distribution rights of an embedded IDR).

13. The Task Force agreed with the staff's proposed changes to the draft abstract provided in the meeting discussion materials[2] and decided to issue a second draft abstract for exposure.

Current EITF Discussion

14. At the March 12, 2008 EITF meeting, the Task Force discussed the comment letters received on the draft abstract and affirmed as a consensus the consensus-for-exposure reached at the November 29, 2007 EITF meeting. The staff also received an application question about how the consensus-for-exposure should be applied for the period presented since available cash for the period presented may not be determined until the subsequent period pursuant to the partnership agreement. That issue is as follows:

Issue 2— Determining when the MLP becomes contractually obligated to make distributions to the GP, LPs, and IDR holder.

15. The Task Force reached a consensus on Issue 2 that the MLP should reflect its contractual obligation to make distributions as of the end of the current reporting period. Therefore, an MLP would reduce (increase) income (loss) from continuing operations (or net income or loss) for the current reporting period by the amount of available cash that has been or will be distributed to the GP, LPs, and IDR holder (or GP with respect to an embedded IDR) for that current reporting period. If distributions to the IDR holder (or GP with respect to an embedded IDR) are contractually limited to available cash as defined in the partnership agreement, then the specified threshold for the current reporting period would be the holder's share of available cash that has been or will be distributed to the IDR holder (or GP with respect to an embedded IDR) for that current reporting period.

Transition

16. This Issue shall be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Earlier application is not permitted. The guidance in this Issue should be applied retrospectively for all financial statements presented.

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[2] See Issue Summary No. 1, Supplement No. 2, dated November 14, 2007.

17. Appendix 07-4A reflects the changes made to the draft abstract as a result of the above decisions (added text is underlined and deleted text is ~~struck out~~).

Board Ratification

18. At its March 26, 2008 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

Status

19. No further EITF discussion is planned.

Appendix 07-4A

EITF ABSTRACTS (DRAFT[*~~1~~])

Issue No. 07-4

Title: ~~"~~Application of the Two-Class Method under FASB Statement No. 128 to Master Limited Partnerships~~"~~

Dates Discussed: June 14, 2007; September 11, 2007; November 29, 2007; ~~[~~March 12~~—13~~, 2008~~]~~

References: FASB Statement No. 128, *Earnings per Share*

AICPA Statement of Position 95-2, "Financial Reporting by Nonpublic Investment Partnerships"

International Accounting Standard 33, *Earnings per Share*

EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128"

EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share"

EITF Topic No. D-72, "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share"

EITF Topic No. D-82, "Effect of Preferred Stock Dividends Payable in Common Shares on Computation of Income Available to Common Stockholders"

Objective

1. **The objective of this Issue is to improve the comparability of earnings per unit (EPU) calculations for master limited partnerships (MLPs) with incentive distribution rights (IDRs) in accordance with Statement 128 and its related interpretations.**

All paragraphs in this Issue have equal authority. **Paragraphs in bold set out the main principles.**

[*~~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.**~~**This draft abstract is being exposed for a public comment period that will end on February 8, 2008.**~~

Background

2. Publicly traded MLPs often issue multiple classes of securities that may participate in partnership distributions according to a formula specified in the partnership agreement. A typical MLP consists of publicly traded common units held by limited partners (LPs), a general partner (GP) interest, and IDRs. Depending on the structure of the MLP, the IDRs may be a separate class of nonvoting limited partner interest that the GP initially holds but generally may transfer or sell apart from its overall interest. Alternatively, the IDRs may be embedded in the GP interest such that they cannot be detached and transferred apart from the GP's overall interest.

3. Generally, the partnership agreement obligates the GP to distribute 100 percent of the partnership's available cash <u>(as defined in the partnership agreement)</u> at the end of each ~~quarter~~ <u>reporting period</u> to the GP and LPs via a distribution waterfall (that is, a schedule that prescribes distributions to the GP and LPs at each threshold) <u>within a contractually determined period of time following the end of a reporting period</u>. When certain thresholds are met, the distribution waterfall further allocates available cash to the holder of the separate class of nonvoting limited partner interest (the IDR holder) or, when the IDR is embedded in the GP interest, to the GP. The net income (or loss) of the partnership is allocated to the capital accounts of the GP and LPs based on their respective sharing of income or losses specified in the partnership agreement, but only after taking into account any priority income allocations resulting from incentive distributions.

4. As a result of the capital structure of MLPs, the partnership is required to apply the two-class method to calculate EPU. Paragraph 61 of Statement 128 describes the two-class method as an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) (that is, distributed earnings) and participation rights in undistributed earnings. Undistributed earnings are allocated to the common unit(s) and participating securities as if all earnings for the period had been distributed. Pursuant to Issue 3 of Issue 03-6, undistributed earnings for a period are allocated to a participating security based on the contractual participation rights of the security to share in those current period earnings as if all earnings for the period had been distributed. When applying the two-class method to the interests of the GP and LPs in MLPs, questions have been raised about the effect of IDRs on the computation of EPU.

Scope

5. **This Issue applies to MLPs that are required to make incentive distributions when certain thresholds have been met that are accounted for as equity distributions.**

6. An MLP may issue IDRs that are a separate class of nonvoting LP interest that the GP initially holds or IDRs that are embedded in the GP interest and therefore cannot be detached or transferred apart from the GP's overall interest. IDRs that are a separate class of non-voting limited partner interest generally may be transferred or sold apart from the GP interest. This Issue applies to all MLPs that (a) are required to make incentive distributions when certain thresholds have been met (regardless of whether the IDRs are a separate LP interest or embedded in the GP interest) and (b) have accounted for the incentive distributions as equity distributions (as opposed to compensation costs). The determination of whether the incentive distribution is an equity distribution or compensation <u>cost</u> ~~expense~~ is outside the scope of this Issue.

Other Presentation Matters

7. **IDRs that are a separate class of LP interest are participating securities because they have a right to participate in earnings with common equity holders. Therefore, current-period earnings shall be allocated to the GP, LP, and IDR holder using the two-class method in Statement 128 to calculate EPU.**

8. When calculating EPU under the two-class method for an MLP, net income (or loss) for the current reporting period shall be reduced (or increased) by ~~distributions~~the amount of available cash that has been or will be distributed to the GP, LPs, and IDR holder for that reporting period ~~presented~~. For example, assume a partnership agreement requires the GP to distribute available cash within 60 days following the end of each fiscal quarter. The MLP is required to file financial statements with a regulatory agency within 45 days following the end of each fiscal quarter. In order to compute EPU for the first quarter, the GP shall determine the amount of available cash that will be distributed to the GP, LPs, and IDR holder for that first quarter. The MLP would reduce (or increase) net income (or loss) by that amount in computing undistributed earnings that must be allocated to the GP, LPs, and IDR holder in calculating EPU for the first quarter.

9. The undistributed earnings, if any, shall be allocated to the GP, LPs, and IDR holder utilizing the contractual terms of the partnership agreement. The distribution waterfall (that is, a schedule that prescribes distributions to the various interest holders at each threshold) for available cash specified in the partnership agreement contractually mandates the way in which earnings are distributed for the period presented. The undistributed earnings shall be allocated to the IDR holder based on the contractual participation rights of the IDR to share in current period earnings. Therefore, if the partnership agreement includes a "specified threshold" as described in Example F in paragraph 16 of Issue 03-6, an MLP shall not allocate undistributed earnings to the IDR holder once the specified threshold has been met.

10. In determining whether a specified threshold exists, an MLP ~~should~~shall evaluate whether distributions to the IDR holder would be contractually limited to available cash as defined in the partnership agreement if all earnings for the period were distributed. For example, if the partnership agreement contractually limits distributions to the IDR holder to the holder's share of available cash as defined in the partnership agreement~~ and all available cash for the period presented has been distributed~~, then the specified threshold for the current reporting period would be the holder's share of available cash that has been or will be distributed for that reporting period. The MLP would not allocate undistributed earnings to the IDR holder because the holder's share of available cash is the maximum amount that the IDR holder would be contractually entitled to receive if all earnings for the current reporting period were distributed. However, if the partnership agreement is silent or does not explicitly limit distributions to the IDR holder to available cash, then the MLP would allocate undistributed earnings to the IDR holder utilizing the distribution waterfall for available cash specified in the partnership agreement.

~~9~~11. Any excess of distributions over earnings shall be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement (that is, the provisions for allocation of losses to the partners' capital accounts for the period presented). If the IDR holders do not share in losses, the excess of distribution over earnings amount would not be allocated to the IDR holders. However, if the IDR holders have a contractual obligation to share in the losses of the MLP on a basis that is objectively determinable (as described in paragraphs 17 and 18 of Issue 03-6), the excess of distributions over earnings shall be allocated to the GP, LPs, and IDR holders based on their respective sharing of losses specified in the partnership agreement for the period presented.

~~10~~12. **IDRs that are embedded in the GP interest are not separate participating securities. However, because the GP and LP interests are separate classes of equity, the two-class method shall be applied in computing EPU for the GP and LP interests.**

~~11~~13. When calculating EPU under the two-class method for an MLP, net income (or loss) for the current reporting period shall be reduced (or increased) by ~~distributions~~the amount of available cash that has been or will be distributed to the GP (including the distribution rights of the embedded IDRs) and LPs for that reporting period ~~presented~~. For example, assume that a partnership agreement requires the GP to distribute available cash within 60 days following the end of each fiscal quarter. The MLP is required to file financial statements with a regulatory agency within 45 days following the end of each fiscal quarter. In order to compute EPU for the first quarter, the GP shall determine the amount of available cash that will be distributed to the GP and LPs for that first quarter. The MLP would reduce (or increase) net income (or loss) by that amount in computing undistributed earnings that must be allocated to the GP (including the distribution rights of the embedded IDRs) and LPs in calculating EPU for the first quarter.

14. Undistributed earnings, if any, shall be allocated to the GP (including the distribution rights of the embedded IDRs) and LPs utilizing the contractual terms of the partnership agreement. The distribution waterfall for available cash specified in the partnership agreement contractually mandates the way in which earnings are distributed for the period presented. The undistributed earnings shall be allocated to the GP (with respect to the distribution rights of an embedded IDR) based on the contractual participation rights of the IDR to share in current period earnings. Therefore, if the partnership agreement includes a "specified threshold" as described in Example F in paragraph 16 of Issue 03-6, an MLP shall not allocate undistributed earnings to the GP (with respect to the distribution rights of an embedded IDR) once the specified threshold has been met.

15. In determining whether a specified threshold exists, an MLP ~~should~~shall evaluate whether distributions to the GP (with respect to the distribution rights of an embedded IDR) would be contractually limited to available cash as defined in the partnership agreement if all earnings for the period were distributed. For example, if the partnership agreement contractually limits distributions to the GP (with respect to the distribution rights of an embedded IDR) to the holder's share of available cash as defined in the partnership agreement ~~and all available cash for the period presented has been distributed~~, then the specified threshold for the current reporting period would be the GP's share (with respect to the distribution rights of an embedded IDR) of available cash that has been or will be distributed for that reporting period. The MLP would not allocate undistributed earnings to the GP (with respect to the distribution rights of an embedded IDR) because the GP's share (with respect to the distribution rights of an embedded IDR) of available cash is the maximum amount that the GP (with respect to the distribution rights of an embedded IDR) would be contractually entitled to receive if all earnings for the current reporting period were distributed. However, if the partnership agreement is silent or does not explicitly limit distributions to the GP (with respect to the distribution rights of an embedded IDR) to available cash, then the MLP would allocate undistributed earnings to the GP (with respect to the distribution rights of an embedded IDR) utilizing the distribution waterfall for available cash specified in the partnership agreement.

16. Any excess of distributions over earnings shall be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement for the period presented.

Transition

~~12~~17. This Issue shall be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Earlier application is not permitted. This Issue shall be applied retrospectively for all financial statements presented.

The provisions of this Issue need not be applied to immaterial items.

Issue No. 07-5

Title: Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock

Dates Discussed: September 11, 2007; November 29, 2007; March 12, 2008

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

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

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

Statement 133 Implementation Issue No. C8, "Derivatives That Are Indexed to both an Entity's Own Stock and Currency Exchange Rates"

Proposed Statement 133 Implementation Issue No. C21, "Whether Options (Including Embedded Conversion Options) Are Indexed to both an Entity's Own Stock and Currency Exchange Rates"

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

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

EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"

EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock"

EITF Issue No. 05-2, "The Meaning of 'Conventional Convertible Debt Instrument' in Issue No. 00-19"

Introduction

1. Paragraph 11(a) of Statement 133 specifies that a contract that would otherwise meet the definition of a derivative under that Statement issued or held by the reporting entity that is **both** (a) indexed to its own stock and (b) classified in stockholders' equity in its statement of financial position should not be considered a derivative financial instrument for purposes of applying that Statement. If a freestanding financial instrument (for example, a stock purchase warrant) meets the scope exception in paragraph 11(a) of Statement 133, it is classified as an equity instrument and is not accounted for as a derivative instrument.

2. Paragraph 12 of Statement 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument pursuant to that Statement if certain criteria are met. One of those criteria, set forth in paragraph 12(c), is that a separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11 of that Statement, be a derivative instrument subject to the requirements of Statement 133. Consequently, if an embedded feature (for example, the conversion option embedded in a convertible debt instrument) meets the scope exception in paragraph 11(a) of

Statement 133, it would not be separated from the host contract and accounted for as a derivative by the issuer.

3. This Issue addresses the determination of whether an instrument (or an embedded feature) is indexed to an entity's own stock, which is the first part of the scope exception in paragraph 11(a) of Statement 133. If an instrument (or an embedded feature) that has the characteristics of a derivative instrument under paragraphs 6–9 of Statement 133 is indexed to an entity's own stock, it is still necessary to evaluate whether it is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument). For example, a net-cash-settled stock purchase warrant may be indexed to an entity's own stock, but it is not classified in stockholders' equity. Other applicable authoritative accounting literature, including Issues 00-19 and 05-2, provides guidance for determining whether an instrument (or an embedded feature) is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument). This Issue does not address that second part of the scope exception in paragraph 11(a) of Statement 133.

4. In addition, some instruments that are potentially subject to the guidance in Issue 00-19 do not have all the characteristics of a derivative instrument under paragraphs 6–9 of Statement 133. For example, a physically settled forward contract to issue an entity's own equity shares in exchange for cash would not meet the net-settlement characteristic of a derivative instrument, as described in paragraphs 6(c) and 9 of Statement 133, if the underlying equity shares are not readily convertible to cash. If the forward contract is considered to be indexed to the entity's own stock, it would be evaluated under Issue 00-19 to determine whether it should be classified in equity or as an asset or a liability. However, if the terms of that forward contract are such that it is not considered to be indexed to the entity's own stock, equity classification would be precluded and the instrument would not be within the scope of Issue 00-19 (that Issue provides accounting guidance for instruments that are **indexed to**, and potentially settled in, the issuer's own stock). Consequently, for certain freestanding instruments that do not have all the characteristics of a derivative instrument under paragraphs 6–9 of Statement 133 but are potentially settled in an entity's own equity shares, this Issue would apply for evaluating whether they are within the scope of Issue 00-19.

5. Issue 01-6 provides guidance on evaluating whether certain instruments and embedded features are indexed to an entity's own stock. Specifically, Issue 01-6 applies to instruments and embedded features containing one or more defined contingencies provided that once a contingency has occurred, the instrument's settlement amount is based solely on the issuing company's own stock. The consensus in Issue 01-6 specifies that instruments within the scope of that Issue are considered indexed to a company's own stock provided that (1) the contingency provisions are not based on (a) an observable market, other than the market for the issuer's stock (if applicable), or (b) an observable index, other than those measured solely by reference to the issuer's own operations, and (2) once the contingent events have occurred, the instrument's settlement amount is based solely on the issuer's own stock. A final consensus on this Issue will supersede the guidance in Issue 01-6.

Scope

6. This Issue applies to any freestanding financial instrument or embedded feature that has all

the characteristics of a derivative in paragraphs 6–9 of Statement 133, for purposes of determining whether that instrument or embedded feature qualifies for the first part of the scope exception in paragraph 11(a) of Statement 133. This Issue also applies to any freestanding financial instrument that is potentially settled in an entity's own stock, regardless of whether the instrument has all the characteristics of a derivative in paragraphs 6–9 of Statement 133, for purposes of determining whether the instrument is within the scope of Issue 00-19.

7. This Issue does not apply to share-based payment awards within the scope of Statement 123(R) for purposes of determining whether instruments are classified as liability awards or equity awards under that Statement.

Prior EITF Discussion

8. The original issues brought to the Task Force at the September 11, 2007 EITF meeting were how an entity should determine whether the following types of instruments or embedded features are indexed to its own stock.

Issue 1— Instruments and embedded features for which exercisability is based on one or more defined contingencies provided that once a contingency has occurred, the instrument's settlement amount is based solely on the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price.

Issue 2— Instruments and embedded features for which (a) the settlement amount is always based on the entity's stock price and one or more other variables or (b) the party receiving shares at settlement has a noncontingent option to deliver noncash consideration whose fair value is affected by one or more variables other than the entity's stock price.

Issue 3— Instruments and embedded features for which the settlement amount is based solely on the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price unless a defined contingency occurs or specified condition is met (including a condition relating to the issuer's share price at settlement). Upon occurrence of the contingent event or other condition, there is an adjustment to the number of shares used to calculate the settlement amount, the strike price, or both.

9. At the September 11, 2007 EITF meeting, the Task Force reached a tentative conclusion on Issue 1 that contingent exercise provisions do not preclude an instrument or embedded feature from being indexed to an entity's own stock, provided that those provisions are not based on (a) an observable market, other than the market for the entity's stock (if applicable), or (b) an observable index, other than those calculated solely by reference to the entity's own operations (for example, sales revenue of the entity, EBITDA [earnings before interest, taxes, depreciation, and amortization] of the entity, net income of the entity, or total equity of the entity). This tentative conclusion reaffirms the existing guidance in Issue 01-6 for purposes of evaluating contingent exercise provisions.

10. The Task Force discussed Issue 2 but was not asked to reach a tentative conclusion.

11. The Task Force reached a tentative conclusion on Issue 3 that an entity must presume the occurrence of a contingent event or other condition that would adjust the settlement terms of that instrument or embedded feature when evaluating whether an instrument or embedded feature is indexed to its own stock.

12. The Task Force requested that the FASB staff form a working group to assist in developing a framework for evaluating whether the instruments and embedded features addressed in Issues 2 and 3 are indexed to an entity's own stock. The Task Force recommended that the Working Group focus on developing a framework under which an instrument or embedded feature would be considered indexed to an entity's own stock if its ultimate settlement amount will equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. An instrument or embedded feature for which the number of shares used to calculate the settlement amount, the strike price, or both, may vary would not be indexed to an entity's own stock unless the only variables that could affect the settlement amount would be inputs to a fair value measurement of any option or forward contract on equity shares (for example, interest rates). However, under that approach, standard antidilution provisions would not preclude an instrument or embedded feature from being indexed to an entity's own stock.

13. Task Force members observed that the tentative conclusions reached on Issues 1 and 3 may be reconsidered after the Working Group provides the Task Force with its recommendations on Issue 2.

14. Based on the tentative conclusions of the Task Force at the September 11, 2007 EITF meeting and after consideration of the input received from the Working Group members, the following two-step approach for determining whether an instrument or embedded feature is indexed to an entity's own stock was developed for the Task Force's consideration at the November 29, 2007 EITF meeting:

Step 1: Evaluate the instrument's contingent exercise provisions, if any.

Step 2: Evaluate the instrument's settlement provisions.

15. Based on the Task Force's tentative conclusion reached at the September 11, 2007 EITF meeting, the existing guidance in Issue 01-6 would be applied under Step 1. If the evaluation of Step 1 would not preclude an instrument from being considered indexed to the entity's own stock, the analysis would proceed to Step 2 and an evaluation of the instrument's settlement provisions would be performed. At the November 29, 2007 EITF meeting, the Task Force was asked to discuss the following issues, related to Issues 2 and 3 discussed at the September 11, 2007 meeting, on the evaluation of settlement provisions for purposes of determining whether an instrument or embedded feature is indexed to an entity's own stock (Step 2 above).

Issue 4(a)— How an entity should evaluate settlement provisions for purposes of determining whether an instrument or embedded feature is indexed to its own stock.

Issue 4(b)— How an entity should evaluate whether instruments (or embedded features) are indexed to its own stock if either (a) the monetary consideration to be exchanged at settlement (that is, the strike price) is not denominated in the entity's functional currency or (b) the shares to be exchanged at settlement are traded only on exchanges (or other established marketplaces) on which trades are not executed in the currency in which the strike price is denominated. This Issue was addressed in proposed Statement 133 Implementation Issue No. C21, which has been put on hold pending the Task Force's deliberations of this Issue.

Issue 4(c)— Whether an exception to the settlement approach should be developed for purposes of evaluating equity-linked financial instruments issued to investors for purposes of establishing a market-based measure of the grant-date fair value of employee stock options (market-based employee stock option valuation instruments).

16. At the November 29, 2007 EITF meeting, the Task Force discussed Issue 4(a) but was not asked to reach a tentative conclusion. The Task Force asked the FASB staff to conduct further research on alternative views and to solicit additional input from the Working Group for discussion at a future meeting. Issues 4(b) and 4(c) were not discussed.

Current EITF Discussion

17. The following Issues were presented to the Task Force for discussion at the March 12, 2008 EITF meeting:

Issue 4(a)— How an entity should evaluate whether an instrument (or embedded feature) is indexed to its own stock.

Issue 4(a)(1)—For purposes of applying guidance developed under Issue 4(a), how the term "standard antidilution provisions" should be defined.

Issue 4(a)(2)—If the Task Force reaches a conclusion on Issue 4(a)(1) that differs from the definition of "standard antidilution provisions" in Issue 05-2, whether a conforming amendment should be made to change the definition of standard antidilution provisions in Issue 05-2.

Issue 4(b)— How the currency in which the strike price of an equity-linked financial instrument (or embedded feature) is denominated affects the determination of whether the instrument is indexed to an entity's own stock.

Issue 4(c)— How an issuer should account for market-based employee stock option valuation instruments.

18. At the March 12, 2008 EITF meeting, the Task Force reached a consensus-for-exposure on Issue 4(a) that an entity should evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock using the following two-step approach:

Step 1: Evaluate the instrument's contingent exercise provisions, if any.
Step 2: Evaluate the instrument's settlement provisions.

19. The Task Force reached a consensus-for-exposure that the guidance in Issue 01-6 should be carried forward to this Issue for purposes of evaluating contingent exercise provisions (Step 1). An exercise contingency would not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on (a) an observable market, other than the market for the issuer's stock (if applicable), or (b) an observable index, other than an index calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer, EBITDA of the issuer, net income of the issuer, or total equity of the issuer). If the evaluation of Step 1 does not preclude an instrument (or embedded feature) from being considered indexed to the entity's own stock, the analysis would proceed to Step 2.

20. For purposes of applying Step 2, an instrument (or embedded feature) would be considered indexed to an entity's own stock if its settlement amount will equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed amount of cash or another financial asset. An issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond would be considered indexed to an entity's own stock. An instrument's strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for any potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control. In cases in which the instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, the Task Force reached a consensus-for-exposure that the instrument would still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value of a "fixed-for-fixed" forward or option on equity shares.

21. A "fixed-for-fixed" forward or option on equity shares has a settlement amount that is equal to the difference between the price of a fixed number of equity shares and a fixed strike price. The fair value inputs of a fixed-for-fixed forward or option on equity shares may include the entity's stock price and additional variables, including the strike price of the instrument, term of the instrument, expected dividends or other dilutive activities, stock borrow cost, interest rates, stock price volatility, the entity's credit spread, and the ability to maintain a standard hedge position in the underlying shares. Determinations and adjustments related to the settlement amount (including the determination of the ability to maintain a standard hedge position) must be commercially reasonable. An instrument (or embedded feature) would not be considered indexed to the entity's own stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares. If an instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares, or if the instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed above in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares, the instrument (or embedded feature) would not be considered indexed to the entity's own stock.

22. Standard pricing models for equity-linked financial instruments contain certain implicit assumptions. One such assumption is that the stock price exposure inherent in those instruments can be hedged by entering into an offsetting position in the underlying equity shares. For

example, the Black-Scholes-Merton option-pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous. Accordingly, for purposes of applying Step 2, fair value inputs include adjustments to neutralize the effects of events that can cause stock price discontinuities. For example, a merger announcement may cause an immediate jump (up or down) in the price of shares underlying an equity-linked option contract. A holder of that instrument would not be able to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change. As a result, changes in (a) the fair value of an equity-linked instrument and (b) the fair value of an offsetting hedge position in the underlying shares will differ, creating a gain or loss for the instrument holder as a result of the merger announcement. Therefore, inclusion of provisions that adjust the terms of the instrument to offset the net gain or loss resulting from a merger announcement or similar event do not preclude an equity-linked instrument (or embedded feature) from being considered indexed to an entity's own stock.

23. Some equity-linked financial instruments contain provisions that provide an entity with the ability to unilaterally modify the terms of the instrument at any time, provided that such modification benefits the counterparty. For example, the terms of a convertible debt instrument may explicitly permit the issuer to reduce the conversion price at any time to induce conversion of the instrument. For purposes of applying Step 2, such provisions do not affect the determination of whether an instrument (or embedded feature) is considered indexed to an entity's own stock.

24. The Task Force observed that Issue 4(a) is intended to replace the guidance in Issue 2 of Issue 01-6. Therefore, if the Task Force reaches a consensus on Issue 07-5 that is consistent with its consensus-for-exposure, Issue 01-6 will be nullified. The guidance in Issue 1 of Issue 01-6, which was unaffected by this Issue, will be carried forward and codified in the abstract for this Issue.

25. The Task Force agreed that the Notice to Recipients included with the draft abstract should include a question regarding whether the guidance in Issue 4(a) is operational and provides a principle that could be applied consistently.

26. The Task Force discussed Issues 4(a)(1) and 4(a)(2), but was not asked to reach a consensus-for-exposure. Some Task Force members were concerned with defining *standard antidilution provisions* in a manner that is inconsistent with the description of antidilution provisions in paragraph A156 of Statement 123(R). Other Task Force members asserted that generally, contractual provisions providing for an adjustment to maintain the value of an equity-linked financial instrument in the event of (a) an equity restructuring transaction (as defined in Statement 123(R)), (b) ordinary dividends, (c) issuances of an entity's shares for an amount that is less than the current fair value of those shares, or (d) repurchases of an entity's shares for an amount that exceeds the current fair value of those shares would not preclude an instrument from being considered indexed to an entity's own stock when assessed using the consensus-for-exposure reached on Issue 4(a). Therefore, it may be unnecessary for the guidance in Issue 4(a) to explicitly state that standard antidilution provisions do not affect the determination of whether an instrument is indexed to an entity's own stock. Those Task Force members observed that Issue 4(a)(1) is not relevant to this Issue if the guidance in Issue 4(a) does not refer to standard

antidilution provisions. The Task Force agreed that the Notice to Recipients included with the draft abstract should include a question regarding whether it is necessary for Issue 4(a) to specify that standard antidilution provisions do not affect the determination of whether an instrument is indexed to an entity's own stock and, if so, how that term should be defined.

27. The Task Force reached a consensus-for-exposure on Issue 4(b) that an equity-linked financial instrument (or embedded feature) would not be considered indexed to the entity's own stock if the strike price is denominated in a currency other than the issuer's functional currency (including a conversion option embedded in a convertible debt instrument that is denominated in a currency other than the issuer's functional currency). The determination of whether an equity-linked financial instrument is indexed to an entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade.

28. The Task Force reached a consensus-for-exposure on Issue 4(c) that market-based employee stock option valuation instruments are not considered indexed to the entity's own stock under the guidance in Issue 4(a) and that an exception to Issue 4(a) should not be provided. Consequently, they do not qualify for the scope exception in paragraph 11(a) of Statement 133. Additionally, such instruments are not within the scope of Statement 123(R), so they do not qualify for the scope exception in paragraph 11(b) of Statement 133. Provided that such instruments (a) have the characteristics of a derivative instrument specified in paragraphs 6–9 of Statement 133 and (b) do not qualify for any other scope exception in that Statement, they should be accounted for as derivative liabilities. (Refer to Example 17 in Appendix 07-5A of the draft abstract attached to these minutes for an illustration of market-based employee stock option valuation instruments.)

29. The tentative conclusions reached on Issues 1 and 3 at the September 11, 2007 EITF meeting have been incorporated into the consensus-for-exposure on Issue 4(a). Consequently, the Task Force was not asked to reach separate consensuses on those Issues.

Transition and Effective Date

30. The Task Force reached a consensus-for-exposure that this Issue should be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early application is not permitted.

31. The Task Force reached a consensus-for-exposure that this Issue shall be applied to outstanding instruments as of the beginning of the fiscal year in which this Issue is initially applied. The cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. The cumulative-effect adjustment is the difference between the amounts recognized in the statement of financial position before initial application of this Issue and the amounts recognized in the statement of financial position at initial application of this Issue. The amounts recognized in the statement of financial position at initial application of this Issue shall be determined based on the amounts that would have been recognized if the guidance in this Issue had been applied from the issuance date of the instrument(s). However, in circumstances in which a previously bifurcated embedded conversion option in a convertible debt instrument no

longer meets the bifurcation criteria in Statement 133 at initial application of this Issue, the carrying amount of the liability for the conversion option (that is, its fair value on the date of adoption) shall be reclassified to shareholders' equity. Any debt discount that was recognized when the conversion option was initially bifurcated from the convertible debt instrument shall continue to be amortized.

32. The Task Force observed that the guidance in Step 1 of Issue 4(a) should not result in a transition adjustment at the effective date of this Issue because that guidance is consistent with the existing guidance in Issue 01-6.

33. The Task Force reached a consensus-for-exposure that the transition disclosures in paragraphs 17 and 18 of Statement 154 should be provided.

Board Ratification

34. At its March 26, 2008 meeting, the Board ratified the consensuses-for-exposure reached by the Task Force in this Issue and approved the issuance of a draft abstract for a public comment period.

Status

35. The draft abstract will be posted to the FASB website after April 1, 2008. Comments on the draft abstract are due by May 5, 2008. Further discussion is expected at a future meeting.

Appendix 07-5A

***EITF ABSTRACTS* (DRAFT[*])**

Issue No. 07-5

Title: Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock

Dates Discussed: September 11, 2007; November 29, 2007; March 12, 2008; [June 11-12, 2008]

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

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

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

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

Statement 133 Implementation Issue No. C8, "Derivatives That Are Indexed to both an Entity's Own Stock and Currency Exchange Rates"

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

EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"

EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock'"

EITF Issue No. 05-2, "The Meaning of 'Conventional Convertible Debt Instrument' in Issue No. 00-19"

Objective

1. **The objective of this Issue is to provide guidance for determining whether an equity-linked financial instrument (or embedded feature) is indexed to an entity's own stock.**

All paragraphs in this Issue have equal authority.
Paragraphs in bold set out the main principles.

[*] **This draft abstract is being exposed for a public comment period that will end on May 5, 2008.**

Background

2. Paragraph 11(a) of Statement 133 specifies that a contract that would otherwise meet the definition of a derivative under that Statement issued or held by the reporting entity that is **both** (a) indexed to its own stock and (b) classified in stockholders' equity in its statement of financial position shall not be considered a derivative financial instrument for purposes of applying that Statement. If a freestanding financial instrument (for example, a stock purchase warrant) meets the scope exception in paragraph 11(a) of Statement 133, it is classified as an equity instrument and is not accounted for as a derivative instrument.

3. Paragraph 12 of Statement 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument pursuant to that Statement if certain criteria are met. One of those criteria, set forth in paragraph 12(c), is that a separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11 of that Statement, be a derivative instrument subject to the requirements of Statement 133. Consequently, if an embedded feature (for example, the conversion option embedded in a convertible debt instrument) meets the scope exception in paragraph 11(a) of Statement 133, it would not be separated from the host contract and accounted for as a derivative by the issuer.

4. This Issue addresses the determination of whether an instrument (or an embedded feature) is indexed to an entity's own stock, which is the first part of the scope exception in paragraph 11(a) of Statement 133. If an instrument (or an embedded feature) that has the characteristics of a derivative instrument under paragraphs 6–9 of Statement 133 is indexed to an entity's own stock, it is still necessary to evaluate whether it is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument). For example, a net-cash-settled stock purchase warrant may be indexed to an entity's own stock, but it is not classified in stockholders' equity. Other applicable authoritative accounting literature, including Issues 00-19 and 05-2, provides guidance for determining whether an instrument (or an embedded feature) is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument). This Issue does not address that second part of the scope exception in paragraph 11(a) of Statement 133.

5. In addition, some instruments that are potentially subject to the guidance in Issue 00-19 do not have all the characteristics of a derivative instrument under paragraphs 6–9 of Statement 133. For example, a physically settled forward contract to issue an entity's own equity shares in exchange for cash would not meet the net-settlement characteristic of a derivative instrument, as described in paragraphs 6(c) and 9 of Statement 133, if the underlying equity shares are not readily convertible to cash. If the forward contract is considered to be indexed to the entity's own stock, it would be evaluated under Issue 00-19 to determine whether it should be classified in equity or as an asset or a liability. However, if the terms of that forward contract are such that it is not considered to be indexed to the entity's own stock, equity classification would be precluded and the instrument would not be within the scope of Issue 00-19 (that Issue provides accounting guidance for instruments that are **indexed to**, and potentially settled in, the issuer's own stock). Consequently, for certain freestanding instruments that do not have all the characteristics of a derivative instrument under paragraphs 6–9 of Statement 133 but are potentially settled in an entity's own equity shares, this Issue would apply for evaluating whether they are within the scope of Issue 00-19.

6. Issue 01-6 is nullified by this Issue. However, some of the guidance previously contained in Issue 01-6 has been carried forward and codified in paragraph 12 of this Issue.

7. The guidance in this Issue shall be applied to the appropriate unit of accounting, as determined under other applicable U.S. GAAP. For example, if an entity issues two freestanding financial instruments and concludes that those two instruments are required to be accounted for separately, then the guidance in this Issue would be applied separately to each instrument. In contrast, if an entity issues two freestanding financial instruments and concludes that those two instruments are required to be linked and accounted for on a combined basis as a single financial instrument (for example, pursuant to the guidance in Statement 133 Implementation Issue K1), then the guidance in this Issue would be applied to the combined financial instrument.

Scope

8. **This Issue applies to any freestanding financial instrument or embedded feature that has all the characteristics of a derivative in paragraphs 6–9 of Statement 133, for purposes of determining whether that instrument or embedded feature qualifies for the first part of the scope exception in paragraph 11(a) of Statement 133. This Issue also applies to any freestanding financial instrument that is potentially settled in an entity's own stock, regardless of whether the instrument has all the characteristics of a derivative in paragraphs 6–9 of Statement 133, for purposes of determining whether the instrument is within the scope of Issue 00-19.**

9. This Issue does not apply to share-based payment awards within the scope of Statement 123(R) for purposes of determining whether instruments are classified as liability awards or equity awards under that Statement. Equity-linked financial instruments issued to investors for purposes of establishing a market-based measure of the grant-date fair value of employee stock options are not within the scope of Statement 123(R) themselves. Consequently, this Issue applies to such market-based employee stock option valuation instruments for purposes of making the determinations described in the preceding paragraph.

10. The guidance in paragraph 12 of this Issue applies to both the issuer and the holder of instruments within the scope of this Issue (as set forth in paragraphs 8 and 9).

Recognition

11**. An entity shall evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock using the following two-step approach:**

Step 1: Evaluate the instrument's contingent exercise provisions, if any.

Step 2: Evaluate the instrument's settlement provisions.

12. Outstanding instruments within the scope of this Issue are always considered issued for accounting purposes, except as discussed in the remainder of this paragraph. In some cases, parties to a business combination exchange contingently exercisable options to purchase equity securities of the other entity, at favorable prices, to encourage successful completion of that combination. If the merger is consummated as proposed, the options expire unexercised. If, however, a specified event occurs that interferes with the planned business combination, the options become exercisable. Such "lock-up options" are not considered issued for accounting purposes unless and until the options become exercisable.

Evaluation of Contingent Exercise Provisions (Step 1)

13. An exercise contingency would not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on (a) an observable market, other than the market for the issuer's stock (if applicable), or (b) an observable index, other than an index calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer, EBITDA [earnings before interest, taxes, depreciation, and amortization] of the issuer, net income of the issuer, or total equity of the issuer). If the evaluation of Step 1 does not preclude an instrument from being considered indexed to the entity's own stock, the analysis would proceed to Step 2.

Evaluation of Settlement Provisions (Step 2)

14. An instrument (or embedded feature) would be considered indexed to an entity's own stock if its settlement amount will equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed amount of cash or another financial asset. An issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond would be considered indexed to an entity's own stock. An instrument's strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for any potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control. If the instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, the instrument (or embedded feature) would still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value of a "fixed-for-fixed" forward or option on equity shares.

15. A "fixed-for-fixed" forward or option on equity shares has a settlement amount that is equal to the difference between the price of a fixed number of equity shares and a fixed strike price. The fair value inputs of a fixed-for-fixed forward or option on equity shares may include the entity's stock price and additional variables, including the strike price of the instrument, term of the instrument, expected dividends or other dilutive activities, stock borrow cost, interest rates, stock price volatility, the entity's credit spread, and the ability to maintain a standard hedge position in the underlying shares. Determinations and adjustments related to the settlement amount (including the determination of the ability to maintain a standard hedge position) must be commercially reasonable. An instrument (or embedded feature) would not be considered indexed to the entity's own stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares. If an instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares, or if the instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed above in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares, the instrument (or embedded feature) would not be considered indexed to the entity's own stock.

16. Standard pricing models for equity-linked financial instruments contain certain implicit assumptions. One such assumption is that the stock price exposure inherent in those instruments can be hedged by entering into an offsetting position in the underlying equity shares. For example, the Black-Scholes-Merton option-pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous. Accordingly, for purposes of applying Step 2, fair value inputs include adjustments to neutralize

the effects of events that can cause stock price discontinuities. For example, a merger announcement may cause an immediate jump (up or down) in the price of shares underlying an equity-linked option contract. A holder of that instrument would not be able to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change. As a result, changes in (a) the fair value of an equity-linked instrument and (b) the fair value of an offsetting hedge position in the underlying shares will differ, creating a gain or loss for the instrument holder as a result of the merger announcement. Therefore, inclusion of provisions that adjust the terms of the instrument to offset the net gain or loss resulting from a merger announcement or similar event do not preclude an equity-linked instrument (or embedded feature) from being considered indexed to an entity's own stock.

17. Some equity-linked financial instruments contain provisions that provide an entity with the ability to unilaterally modify the terms of the instrument at any time, provided that such modification benefits the counterparty. For example, the terms of a convertible debt instrument may explicitly permit the issuer to reduce the conversion price at any time to induce conversion of the instrument. For purposes of applying Step 2, such provisions do not affect the determination of whether an instrument (or embedded feature) is considered indexed to an entity's own stock.

Evaluation of Settlement Provisions (Step 2) When the Strike Price of an Equity-Linked Financial Instrument Is Denominated In a Foreign Currency

18. An equity-linked financial instrument (or embedded feature) would not be considered indexed to the entity's own stock if the strike price is denominated in a currency other than the issuer's functional currency (including a conversion option embedded in a convertible debt instrument that is denominated in a currency other than the issuer's functional currency). The determination of whether an equity-linked financial instrument is indexed to an entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade.

Transition

19. This Issue is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early application is not permitted.

20. The guidance in this Issue shall be applied to outstanding instruments as of the beginning of the fiscal year in which this Issue is initially applied. The cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. The cumulative-effect adjustment is the difference between the amounts recognized in the statement of financial position before initial application of this Issue and the amounts recognized in the statement of financial position at initial application of this Issue. The amounts recognized in the statement of financial position at initial application of this Issue shall be determined based on the amounts that would have been recognized if the guidance in this Issue had been applied from the issuance date of the instrument(s). However, in circumstances in which a previously bifurcated embedded conversion option in a convertible debt instrument no longer meets the bifurcation criteria in Statement 133 at initial application of this Issue, the carrying amount of the liability for the conversion option (that is, its fair value on the date of adoption) shall be reclassified to

shareholders' equity. Any debt discount that was recognized when the conversion option was initially bifurcated from the convertible debt instrument shall continue to be amortized.

21. Paragraphs 12 and 13 of this Issue shall not result in a transition adjustment at the effective date because that guidance is consistent with guidance previously contained in Issue 01-6, which is nullified by this Issue.

22. The transition disclosures in paragraphs 17 and 18 of Statement 154 shall be provided.

The provisions of this Issue need not be applied to immaterial items.

Exhibit 07-5A

ILLUSTRATIVE EXAMPLES OF ISSUE 07-5

The following examples illustrate the application of this Issue for purposes of determining whether an instrument (or embedded feature) is indexed to an entity's own stock, which is the first part of the scope exception in paragraph 11(a) of Statement 133. These examples do not address whether the instrument (or embedded feature) is classified in equity (or would be classified in equity if freestanding), which is the second part of the scope exception in paragraph 11(a) of Statement 133. These examples also do not address whether the instrument is within the scope of Statement 150.

<u>Example 1</u>
Company A issues warrants that permit the holder to buy 100 shares of its common stock at $10 per share. The warrants have 10-year terms; however, they only become exercisable if Company A completes an initial public offering.

Analysis: The warrants are considered indexed to Company A's own stock based on the following evaluation:

Step 1: The exercise contingency (that is, the initial public offering) is not an observable market or an observable index, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

Step 2: Upon exercise, the settlement consideration would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share).

<u>Example 2</u>
Company A issues warrants that permit the holder to buy 100 shares of its common stock at $10 per share. The warrants have 10-year terms; however, they only become exercisable after Company A accumulates $100,000,000 in sales to third parties.

Analysis: The warrants are considered indexed to Company A's own stock based on the following evaluation:

Step 1: The exercise contingency (that is, the accumulation of $100,000,000 in sales to third parties) is an observable index. However, it can only be calculated or measured by reference to Company A's sales, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

Step 2: Upon exercise, the settlement consideration would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share).

<u>Example 3</u>
Company A issues warrants that permit the holder to buy 100 shares of its common stock at $10 per share. The warrants have 10-year terms; however, they only become exercisable if the S&P 500 index increases 500 points within any given calendar year during that 10-year period.

Analysis: The warrants are not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The exercise contingency (that is, the increase of 500 points in the S&P 500 index) is based on an observable index that is not measured solely by reference to the issuer's own operations. It is not necessary to evaluate Step 2.

Step 2: N/A

Example 4

Company A issues warrants that permit the holder to buy 100 shares of its common stock in exchange for one ounce of gold. The warrants have 10-year terms; however, they only become exercisable if Company A completes an initial public offering.

Analysis: The warrants are not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The exercise contingency (that is, the initial public offering) is not an observable market or an observable index, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

Step 2: The settlement consideration would not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price varies based on the price of one ounce of gold. The price of gold is not an input to the fair value of a "fixed-for-fixed" option on equity shares.

Example 5

Company A issues warrants that permit the holder to buy 100 shares of its common stock at $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that if there is an announcement of a merger involving Company A, the strike price of the warrants will be adjusted to offset the effect of the merger announcement on the net change in the fair value of (a) the warrants and (b) an offsetting hedge position in the underlying shares. The strike price adjustment must be determined using commercially reasonable means based on an assumption that the counterparty has entered into a hedge position in the underlying shares to offset the share price exposure from the warrants. That strike price adjustment is not affected by the counterparty's actual hedging position (for example, the strike price adjustment does not differ in circumstances when the counterparty is over-hedged or under-hedged).

Analysis: The warrants are considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement consideration would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share), unless there is a merger announcement. If there is a merger announcement, the settlement consideration would be adjusted to offset the effect of the merger announcement on the fair value of the warrants. In that circumstance, the only variables that could affect the settlement amount would be inputs to the fair value of a "fixed-for-fixed" option on equity shares. Refer to paragraph 16 of this Issue for further discussion.

Example 6

Company A issues warrants that permit the holder to buy 100 shares of its common stock for an initial price of $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that the strike price is reduced by $0.50 after any year in which Company A does not achieve revenues of at least $100 million.

Analysis: The warrants are not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement consideration would not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price would be adjusted after any year in which Company A does not achieve revenues of at least $100 million. The amount of an entity's annual revenues is not an input to the fair value of a "fixed-for-fixed" option on equity shares.

Example 7

Company A purchases net-settled call options that permit it to buy 100 shares of its common stock for $10 per share. However, the maximum appreciation on the call options is capped when Company A's stock price reaches $15 per share (that is, the counterparty's maximum obligation is $500 [($15 − $10) × 100 shares]). The call options have 10-year terms and are exercisable at any time.

Analysis: The call options are considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement consideration would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price when Company A's stock price is between the $10 stated exercise price and the $15 price cap. However, whenever Company A's stock price exceeds $15, the strike price of the call options increases and decreases in amounts equal to the corresponding increases and decreases in Company A's stock price, such that the intrinsic value of each call option always equals $5. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a "fixed-for-fixed" option contract, the call options are considered indexed to the entity's own stock.

Example 8

Company A, whose functional currency is U.S. dollars (US$), issues warrants with a strike price denominated in Canadian dollars (CAN$). The warrants permit the holder to buy 100 shares of its common stock for CAN$10 per share. Company A's shares trade on an exchange on which trades are denominated in CAN$. The warrants have 10-year terms and are exercisable at any time.

Analysis: The warrants are not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The strike price of the warrants is denominated in a currency other than the entity's functional currency, so the warrants are not considered indexed to the entity's own stock.

<u>Example 9</u>

Company A enters into a forward contract to sell 100 shares of its common stock for $10 per share in 1 year. Historically, Company A has paid a dividend of $0.10 per quarter on its common shares. Under the terms of the forward contract, if dividends per common share differ from $0.10 during any 3-month period, the strike price of the forward contract will be adjusted to offset the effect of the dividend differential (actual dividend versus $0.10) on the fair value of the instrument. Additionally, the terms of the forward contract provide for an adjustment to the strike price, using commercially reasonable means, to offset the effect of any increased cost of borrowing Company A's shares in the stock loan market on the fair value of the instrument.

Analysis: The forward contract is considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The only circumstances in which the settlement consideration will not equal the difference between the fair value of 100 shares and $1,000 ($10 per share) are (a) if dividends per common share differ from $0.10 during any 3-month period or (b) there is an increased cost of borrowing Company A's shares in the stock loan market. The adjustments to the strike price resulting from those events are intended to offset their effects on the instrument's fair value. In those circumstances, the only variables that could affect the settlement amount (dividends and stock borrow cost) would be inputs to the fair value of a "fixed-for-fixed" forward contract on equity shares.

<u>Example 10</u>

Company A enters into a forward contract to sell 100 shares of its common stock in 1 year for an amount equal to $10 per share plus interest calculated at a variable interest rate (Federal Funds rate plus a fixed spread).

Analysis: The forward contract is considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement consideration will not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. However, the only variable that causes the settlement consideration to differ from a fixed-for-fixed settlement amount is an interest rate index and the pricing inputs of a fixed-for-fixed forward contract include interest rates. Additionally, the floating interest rate feature does not introduce a leverage factor or otherwise increase the effects of interest rate changes on the instrument's fair value.

<u>Example 11</u>

Company A enters into a forward contract to sell 100 shares of its common stock in 1 year for an amount equal to $10 per share plus interest calculated at a variable interest rate that varies inversely with changes in LIBOR (similar to an "inverse floater," as described in paragraph 178 of Statement 133).

Analysis: The forward contract is not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement consideration will not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price varies inversely with changes in an interest rate index. The inverse floating interest rate feature increases the effects of interest rate changes on the instrument's fair value (that is, the feature increases the instrument's fair value exposure to interest rate changes).

Example 12

Company A enters into a net-settled forward contract to sell 100 shares of its common stock in 1 year for $1,000. However, the maximum amount payable to the counterparty at maturity is capped when Company A's stock price is greater than or equal to $15 per share (that is, Company A's maximum obligation is $500 [($15 − $10) × 100 shares]). Additionally, the maximum amount receivable from the counterparty at maturity is capped when Company A's stock price is less than or equal to $5 per share (that is, the counterparty's maximum obligation is $500 [($5 − $10) × 100 shares]).

Analysis: The forward contract is considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement consideration would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($1,000) when Company A's stock price is between $5 and $15. However, whenever Company A's stock price is greater than or equal to $15 at maturity, the amount payable to the counterparty always equals $500. Additionally, whenever Company A's stock price is less than or equal to $5 at maturity, the amount receivable from the counterparty always equals $500. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a "fixed-for-fixed" forward contract, the instrument is considered indexed to the entity's own stock.

Example 13

Company A enters into a forward contract to sell a variable number of its common shares in 1 year for $1,000. If Company A's stock price is equal to or less than $10 at maturity, Company A will issue 100 shares of its common stock to the counterparty. If Company A's stock price is greater than $10 but equal to or less than $12 at maturity, Company A will issue a variable number of its common shares worth $1,000. Finally, if the share price is greater than $12 at maturity, Company A will issue 83.33 shares of its common stock.

Analysis: The forward contract is considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement consideration will not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price ($1,000). Although the strike price to be received at settlement is fixed, the number of shares to be issued to the counterparty varies based on the entity's stock price on the settlement date. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a "fixed-for-fixed" forward contract on equity shares, the instrument is considered indexed to the entity's own stock.

<u>Example 14</u>
Company A, whose functional currency is US$, enters into a forward contract that requires Company A to sell 100 shares of its common stock for 120 euros (EUR) per share in 1 year.

Analysis: The forward contract is not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The strike price of the forward contract is denominated in a currency other than the entity's functional currency, so the forward contract is not considered indexed to the entity's own stock.

<u>Example 15</u>
Company A issues a contingently convertible debt instrument (CoCo) with a par value of $1,000 that is convertible into 100 shares of its common stock. The convertible debt instrument has a 10-year term and is convertible at any time after one of the following events occurs: (a) Company A's stock price exceeds $13 per share (market price trigger), (b) the convertible debt instrument trades for an amount that is less than 98 percent of its if-converted value (parity provision), or (c) there is an announcement of a merger involving Company A. The terms of the convertible debt instrument also include a "make whole" provision. Under that provision, if Company A is acquired for cash before a specified date, the holder of the convertible debt instrument can convert into a number of shares equal to the sum of (a) the fixed conversion ratio (100 shares per bond) and (b) the "make-whole" shares. The number of make-whole shares is determined by reference to a table with axes of stock price and time.

Analysis: The embedded conversion option is considered indexed to Company A's own stock based on the following evaluation:

Step 1: The market price trigger and parity provision exercise contingencies are based on observable markets; however, those contingencies relate solely to the market prices of the entity's own stock and its own convertible debt. Also, the merger announcement exercise contingency is not an observable market or an index. Therefore, Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

Step 2: An acquisition for cash prior to the specified date is the only circumstance in which the settlement consideration will not equal the difference between the fair value of 100 shares and a fixed strike price ($1,000 fixed par value of the debt). The settlement consideration if Company A is acquired for cash prior to the specified date is equal to the sum of (a) the fixed conversion ratio (100 shares per bond) and (b) the "make-whole" shares. The number of make-whole shares is determined based on a table with axes of stock price and time, which would both be inputs in a fair value measurement of a "fixed-for-fixed" option on equity shares.

Example 16

Company A, whose functional currency is the Chinese yuan (CNY), issues a debt instrument denominated in CNY with a par value of CNY1,000 that is convertible into 100 shares of its common stock. Company A's shares only trade on an exchange in which trades are denominated in US$. Those shares do not trade on an exchange (or other established marketplace) in which trades are denominated in CNY. The convertible debt instrument has a 10-year term and is convertible at any time.

Analysis: The embedded conversion option is considered indexed to Company A's own stock based on the following evaluation:

Step 1: The embedded conversion option does not contain an exercise contingency. Proceed to Step 2.

Step 2: Upon exercise of the embedded conversion option, the settlement consideration would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price denominated in its functional currency (CNY1,000 fixed par value of the debt). The determination of whether the embedded conversion option is indexed to the entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade.

Example 17

Company A issues a security to investors for purposes of establishing a market-based measure of the grant-date fair value of a grant of employee stock options. Under the terms of that market-based employee stock option valuation instrument, Company A is obligated to make variable quarterly payments to the investors that are a function of the net intrinsic value received by a pool of Company A's employees, based on actual stock option exercises by those employees each period. The market-based employee stock option valuation instrument has a 10-year term, consistent with the contractual term of the underlying employee stock options.

Analysis: The market-based employee stock option valuation instrument is not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement consideration will not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. The instrument provides for variable quarterly payments to investors that are based on actual employee stock option exercises for the period. Because a variable that affects the instrument's settlement amount is employee stock option exercise behavior, which is not an input to the fair value of a "fixed-for-fixed" option or forward contract on equity shares, the instrument is not considered indexed to the entity's own stock.

Issue No. 08-1

Title: Revenue Recognition for a Single Unit of Accounting

Date Discussed: March 12, 2008

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

FASB Statement No. 45, *Accounting for Franchise Fee Revenue*

FASB Statement No. 66, *Accounting for Sales of Real Estate*

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

FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Interest Guarantees of Indebtedness of Others*

FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*

FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*

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

AICPA Statement of Position 00-2, *Accounting by Producers or Distributors of Films*

SEC Staff Accounting Bulletin No. 101, Topic 13, *Revenue Recognition*

EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables"

Introduction

1. Entities often enter into revenue arrangements that provide for multiple payment streams for a single unit of accounting. For example, a service provider may receive an up-front payment upon signing a service contract with a customer and then receive additional payments as services are provided to that customer. Other examples can be more complex, such as in biotechnology and pharmaceutical research and development arrangements involving multiple deliverables, up-front payments, payments for specific services, and payments upon achievement of certain clinical milestones. If delivery of a single unit of accounting spans multiple accounting periods, an entity needs to determine how to allocate the multiple payment streams (arrangement consideration) attributable to that unit of accounting to those accounting periods.

2. The ultimate objective of attributing arrangement consideration to a single unit of accounting is to determine when the arrangement consideration should be recognized as revenue. The fundamental goals of recognition, as set forth in Concepts Statement 5, paragraph 83, are that "recognition involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important

consideration." Generally,[1] revenue is considered both earned and realizable when all of the following four conditions are met:

a. Persuasive evidence of an arrangement exists
b. The arrangement fee if fixed or determinable
c. Delivery or performance has occurred
d. Collectibility is reasonably assured.

3. For purposes of this Issue, it is assumed that all of the conditions have been met except for the occurrence of delivery or performance. As an entity evaluates what attribution model to apply to its specific facts and circumstances, it must consider when delivery or performance will occur and not when it will receive arrangement consideration. The issues of when and whether the entity will receive arrangement consideration, including whether it will receive additional payments that are not fixed or determinable upon consummation of the arrangement, relates to whether the arrangement consideration is fixed or determinable and whether collectibility is reasonably assured, neither of which is addressed by this Issue. This Issue addresses the revenue recognition pattern associated with the fixed or determinable arrangement consideration.

4. Furthermore, this Issue does not address whether an arrangement is comprised of one or more deliverables or whether multiple deliverables within an arrangement meet the separation requirements of Issue 00-21. This Issue only addresses the revenue recognition pattern appropriate for a single deliverable or multiple deliverables accounted for as a single unit of accounting in accordance with Issue 00-21.

5. Generally, delivery or performance of a deliverable is considered to have occurred when the seller has fulfilled its obligations related to that deliverable and the customer has realized the value of the deliverable. The FASB staff understands that constituents have adopted various accounting methods to address the issue of when delivery has occurred and, consequently, when revenue should be recognized. This Issue does not address which method is appropriate in any particular circumstance but, rather, addresses whether a multiple attribution model may be appropriate in certain circumstances. This Issue addresses the issue of whether a multiple attribution model can be used for an arrangement consisting of a single deliverable or for a single unit of accounting consisting of multiple deliverables.

6. Under a single attribution model, all arrangement consideration is recognized using a single method, such as either a systematic basis over the term of the arrangement or a per unit basis, but not both. Under a multiple attribution model, arrangement consideration may be recognized using multiple methods, such as both a systematic basis and a per unit basis (for example, an up-front payment may be recognized on a straight-line basis over the term of the arrangement, while a price paid per unit may be recognized as units are delivered) for the single unit of accounting.

[1] References to the four conditions can be found in SAB Topic 13A1; SOP 97-2, paragraph 8; SOP 00-2, paragraph 7, and other revenue recognition accounting literature.

Issues

7. The Issues are:

Issue 1— Whether, under certain facts and circumstances, it may be acceptable to use a multiple attribution model to account for a single unit of accounting consisting of a single deliverable.

Issue 2— Whether, under certain facts and circumstances, it may be acceptable to use a multiple attribution model to account for a single unit of accounting consisting of multiple deliverables.

Scope

8. The guidance in this Issue applies to a single unit of accounting (consisting of either a single deliverable or multiple deliverables) within a revenue arrangement, unless all of the deliverables within that unit of accounting are within the scope of other authoritative literature that provides attribution guidance.

Current EITF Discussion

9. At the March 12, 2008 EITF meeting, the Task Force discussed this Issue but was not asked to reach a conclusion. The Task Force requested that the FASB staff perform additional research on the transactions that give rise to the practice concern addressed by this Issue.

Status

10. Further discussion is expected at a future meeting.

Issue No. 08-2

Title: Lessor Revenue Recognition for Maintenance Services

Date Discussed: March 12, 2008

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

FASB Statement No. 29, *Determining Contingent Rentals*

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

FASB Technical Bulletin No. 90-1, "Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts"

FASB Staff Position AUG AIR-1, *Accounting for Planned Major Maintenance Activities*

FASB Concept Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

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

APB Opinion No. 22, *Disclosure of Accounting Policies*

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

AICPA Statement of Position 00-2, *Accounting for Producers or Distributors of Films*

SEC Staff Accounting Bulletin Topic 13, *Revenue Recognition*

International Accounting Standard 17, *Leases*

International Financial Reporting Interpretations Committee Interpretation 4, "Determining whether an Arrangement contains a Lease"

EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables"

EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease"

Introduction

1. Certain leasing arrangements require the lessor to maintain the leased asset during the lease term. The maintenance services can range from janitorial services in an office space lease to planned major maintenance for an aircraft lease. The portion of the lease payments that is attributed to the maintenance services may or may not be explicitly stated in the lease agreement, and the timing of those payments may not coincide with the performance of the maintenance services. Statement 13 provides that executory costs such as maintenance, insurance, and taxes, together with any profit thereon, shall be excluded from minimum lease payments. However, Statement 13 provides no guidance on the accounting for executory costs, other than excluding them from the determination of minimum lease payments. At issue is how a lessor should account for payments it receives in connection with performing maintenance services to the

leased item, in lease agreements or other arrangements accounted for as leases (hereinafter referred to as "maintenance services").

2. The issue exists in the airline, utility, and real estate industries, and may exist in other industries. Lessors bill for maintenance services in various ways. For example, in a "gross lease" of office space, maintenance is included in the base rent billed to the lessee. In other situations, maintenance is billed separately as a common area maintenance (CAM) charge based on an agreed upon fixed rate per square foot. In some situations, maintenance is invoiced by the lessor to the lessee as services are performed by the lessor. The accounting for maintenance services varies among lessors. For example, some lessors recognize revenue from maintenance service on a straight-line basis as part of the related rental income. Others record maintenance income as it is billed (which may or may not coincide with the performance of the maintenance services).

3. Existing accounting literature is unclear as to how lessors should recognize revenue for maintenance services that are considered executory costs in Statement 13. Furthermore, some assert that in certain instances, maintenance services may be so significant that those services should not be considered a lease-related executory cost but rather "other services" (that is, a non-Statement 13 deliverable). Moreover, lessors may be performing a wide variety of maintenance services under the leasing arrangement (for example, periodic cleaning services and non-routine major maintenance); accordingly, some assert that an analysis should be performed to determine whether the different maintenance "deliverables" under the arrangement are separate units of accounting (regardless of whether the maintenance services are considered an executory cost under Statement 13). There are two views in practice under which maintenance services could be a separate deliverable using the guidance in Issue 00-21: (a) the maintenance services are considered a non-Statement 13 deliverable ("other services") or (b) the maintenance services are considered a Statement 13 deliverable (executory costs) but because different maintenance services are provided by the lessor, Issue 00-21 is used to determine the unit of accounting for those services. This Issue does not address the determination of when the different maintenance services provided by a lessor would represent multiple deliverables under Issue 00-21.

Issues

4. The Issues are:

Issue 1— Whether the scope of this Issue should include all payments for maintenance services in an arrangement accounted for as a lease

Issue 2— How a lessor should recognize revenue related to maintenance services.

Scope

5. The guidance in this Issue applies to arrangements identified as leases as well as arrangements that convey the right to use property, plant, or equipment, and are accounted for as leases based on the guidance in Issue 01-8. Power purchase agreements, airline capacity purchase arrangements, and take-or-pay contracts are common examples (but not an exhaustive list) of arrangements that may contain a lease under Issue 01-8. However, this Issue does not

apply to maintenance services that are provided under a separate arrangement that are within the scope of Technical Bulletin 90-1 or that are not associated with a related leased asset.

Current EITF Discussion

6. At the March 12, 2008 EITF meeting, the Task Force discussed Issue 1 but was not asked to reach a conclusion. The Task Force requested that the FASB staff perform additional research on the types of arrangements that this Issue may apply to and provide further analysis of when payments for maintenance in those arrangements would be considered executory costs, other service provided by the lessor, or part of the lease payment for the leased item. The Task Force also asked the staff to perform further research on the interaction of this Issue with the conclusions reached in FSP AUG AIR-1.

7. The Task Force reached a tentative conclusion on Issue 2 that revenue related to maintenance services should be recognized into income as those services are performed utilizing a proportional performance method that is determined to be the most appropriate method under the circumstances. This tentative conclusion may be revisited pending the outcome of future discussion on Issue 1.

Status

8. Further discussion is expected at a future meeting.

Issue No. 08-3

Title: Accounting by Lessees for Nonrefundable Maintenance Deposits

Date Discussed: March 12, 2008

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

FASB Statement No. 13, *Accounting for Leases*

FASB Statement No. 29, *Determining Contingent Rentals*

FASB Statement No. 154, Accounting Changes and Error Corrections

FASB Interpretation No. 19, *Lessee Guarantee of the Residual Value of Leased Property*

FASB Staff Position AUG AIR-1, *Accounting for Planned Major Maintenance Activities*

International Accounting Standard 17, *Leases*

Introduction

1. Under certain equipment lease agreements, a lessee is legally and contractually responsible for repair and maintenance of the leased asset throughout the lease term. Additionally, certain lease agreements include provisions requiring the lessee to make deposits[1] to the lessor in order to financially protect the lessor in the event the lessee does not properly maintain the leased asset.

2. Under a typical arrangement, those deposits are calculated based on a performance measure, such as hours of use of the leased asset, and are contractually required under the terms of the lease agreement to be used to reimburse the lessee for required maintenance of the leased asset upon the completion of that maintenance. The lessor is contractually required to reimburse the lessee for the maintenance costs paid by the lessee, to the extent of the amounts on deposit.

3. The maintenance deposits made under the lease agreement do not transfer to the lessor either the obligation to maintain the asset or the cost or quality risk associated with the maintenance activities. Whether or not there are available reimbursable deposits, the lessee remains legally responsible for maintaining the leased asset throughout the lease term pursuant to the applicable provisions of the lease.

4. There may be cases in which the total cost of cumulative maintenance events over the term of the lease is less than the cumulative deposits, resulting in excess amounts on deposit at the expiration of the lease. In those cases, some lease agreements provide that the lessor is entitled to retain such excess amounts (nonrefundable maintenance deposit); whereas other agreements

[1] Lease agreements often refer to these deposits as "maintenance reserves" or "supplemental rent." However, the lessor is required to reimburse the deposits to the lessee upon the completion of maintenance activities that the lessee is contractually required to perform under the lease agreement.

specifically provide that, at the expiration of the lease agreement, such excess amounts are returned to the lessee (refundable maintenance deposit).

5. Diversity in practice exists with respect to the accounting for nonrefundable maintenance deposits. Some account for the payments as a deposit. When the underlying maintenance is performed, the deposit is expensed or capitalized in accordance with the lessee's maintenance accounting policy. Once it is determined that an amount is not probable of being used to fund future maintenance expense, it is recognized as additional expense at the time such determination is made. Others account for the payments as contingent rent expense or maintenance expense when the initial payment is made. When the underlying maintenance is performed, maintenance expense is recorded and any reimbursement is credited to rent expense (or maintenance expense).

Issue

6. The Issue is whether lessees should account for nonrefundable maintenance deposits as a deposit or as contingent rental expense.

Scope

7. The scope of this Issue is limited to nonrefundable maintenance deposits paid by a lessee under an arrangement accounted for as a lease. Deposits that are not substantively and contractually related to maintenance of the leased asset are not within the scope of this Issue.

Current EITF Discussion

8. At the March 12, 2008 EITF meeting, the Task Force reached a consensus-for-exposure that all nonrefundable maintenance deposits should be accounted for as a deposit. When the underlying maintenance is performed, the deposit is expensed or capitalized in accordance with the lessee's maintenance accounting policy. Once it is determined that an amount on deposit is not probable of being used to fund future maintenance expense, it is recognized as additional expense at the time such determination is made.

Effective Date and Transition

9. The Task Force reached a consensus-for-exposure that this Issue should be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Earlier application is not permitted.

10. The Task Force reached a consensus-for-exposure that entities should recognize the effect of the change as a change in accounting principle as of the beginning of the fiscal year in which this consensus is initially applied for all arrangements existing at the effective date. The cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. The transition impact of applying this Issue should comply with the disclosure requirements of Statement 154 for changes in accounting principles.

Board Ratification

11. At its March 26, 2008 meeting, the Board ratified the consensuses-for-exposure reached by the Task Force in this Issue and approved the issuance of a draft abstract for a public comment period.

Status

12. The draft abstract will be posted to the FASB website after April 1, 2008. Comments on the draft abstract are due by May 5, 2008.

Appendix 08-3A

EITF ABSTRACTS (DRAFT*)

Issue No. 08-3

Title: Accounting by Lessees for Nonrefundable Maintenance Deposits

Dates Discussed: March 12, 2008; [June 11–12, 2008]

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

FASB Statement No. 13, *Accounting for Leases*

FASB Statement No. 29, *Determining Contingent Rentals*

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

FASB Interpretation No. 19, *Lessee Guarantee of the Residual Value of Leased Property*

FASB Staff Position, AUG AIR-1, *Accounting for Planned Major Maintenance Activities*

International Accounting Standard 17, *Leases*

Objective

1. **The objective of this Issue is to clarify how a lessee shall account for a nonrefundable maintenance deposit under an arrangement accounted for as a lease.**

All paragraphs in this Issue have equal authority.
Paragraphs in bold set out the main principles.

Background

2. Under certain equipment lease agreements, a lessee is legally or contractually responsible for repair and maintenance of the leased asset throughout the lease term. Additionally, certain lease agreements include provisions requiring the lessee to make deposits[1] to the lessor in order to financially protect the lessor in the event the lessee does not properly maintain the leased asset.

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* **This draft abstract is being exposed for a public comment period that will end on May 5, 2008.**

[1] Lease agreements often refer to these deposits as "maintenance reserves" or "supplemental rent." However, the lessor is required to reimburse the deposits to the lessee upon the completion of maintenance activities that the lessee is contractually required to perform under the lease agreement.

3. Under a typical arrangement, those deposits are calculated based on a performance measure, such as hours of use of the leased asset, and are contractually required under the terms of the lease agreement to be used to reimburse the lessee for required maintenance of the leased asset upon the completion of that maintenance. The lessor is contractually required to reimburse the lessee for the maintenance costs paid by the lessee, to the extent of the amounts on deposit.

4. In some cases, the total cost of cumulative maintenance events over the term of the lease is less than the cumulative deposits, resulting in excess amounts on deposit at the expiration of the lease. In those cases, some lease agreements provide that the lessor is entitled to retain such excess amounts (nonrefundable maintenance deposit); whereas other agreements specifically provide that, at the expiration of the lease agreement, such excess amounts are returned to the lessee (refundable maintenance deposit). Refundable maintenance deposits are accounted for as a deposit but diversity has developed on the accounting for nonrefundable maintenance deposits.

Scope

5. **The scope of this Issue is limited to nonrefundable maintenance deposits paid by a lessee under an arrangement accounted for as a lease.**

6. Deposits that are not substantively and contractually related to maintenance of the leased asset are not within the scope of this Issue.

Recognition

7. **Nonrefundable maintenance deposits shall be accounted for as a deposit asset**.

8. When the underlying maintenance is performed, the deposit shall be expensed or capitalized in accordance with the lessee's maintenance accounting policy. Once it is determined that an amount on deposit is not probable of being used to fund future maintenance expense, it shall be recognized as additional expense at the time such determination is made.

Transition

9. This Issue is effective for fiscal years beginning after December 15, 2008, including interim periods within those fiscal years. Earlier application is not permitted.

10. Entities shall recognize the effect of the change as a change in accounting principle as of the beginning of the fiscal year in which this consensus is initially applied for all arrangements existing at the effective date. The cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. The cumulative-effect adjustment is the difference between the amounts recognized in the statement of financial position before initial application of this Issue and the amounts recognized in the statement of financial position at initial application of this Issue.

11. The transition impact of applying this Issue shall comply with the disclosure requirements of Statement 154 for changes in accounting principles.

The provisions of this Issue need not be applied to immaterial items.

Status of Open Issues and Agenda Committee Items

The following represents the FASB staff's assessment of the status and immediate plans with respect to the open Issues on the Task Force's agenda. The Issues on the proposed agenda for the March 12, 2008 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	EITF Liaison	FASB Staff	Immediate Plans	Due Date - Next Deliverable
07-5	Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock	9/07	9/11, 11/07, 3/08	6/08	Bielstein	Stevens/ Malcolm	The FASB staff will prepare an Issue Supplement for a future meeting	Draft Abstract comment period closes May 5, 2008. June 11-12, 2008 EITF meeting
08-1	Revenue Recognition for a Single Unit of Accounting	1/08	3/08	6/08	Uhl	Maples/ Wilks/ Elsbree	The FASB staff will prepare an Issue Supplement for a future meeting	June 11-12, 2008 EITF meeting

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	EITF Liaison	FASB Staff	Immediate Plans	Due Date - Next Deliverable
08-2	Lessor Revenue Recognition for Maintenance Services	1/08	3/08	6/08	Hanson	Leverenz/ Nickell	The FASB staff will prepare an Issue Supplement for a future meeting	June 11-12, 2008 EITF meeting
08-3	Accounting by Lessees for Nonrefundable Maintenance Deposits	1/08	3/08	6/08	Hanson	Nickell/ Leverenz	The FASB staff will prepare an Issue Supplement for a future meeting	Draft Abstract comment period closes May 5, 2008. June 11-12, 2008 EITF meeting
08-4	Transition Guidance for Conforming Changes to Issue No. 98-5	3/08	3/08	6/08	N/A	Zecher/ Stevens	The FASB staff will prepare an Issue Supplement for a future meeting	Draft Abstract comment period closes May 5, 2008. June 11-12, 2008 EITF meeting

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	**Description**	**Date Added**	**Date(s) Discussed**	**Next Meeting**	**FASB Staff**	**Immediate Plans**	**Due Date - Next Deliverable**
02-D	The Effect of Dual-Indexation both to a Company's Own Stock and to Interest Rates and the Company's Credit Risk in Evaluating the Exception under Paragraph 11(a)(1) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*	3/02	N/A	Not scheduled	TBD	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	11/02	N/A	Not scheduled	TBD	The Board's project on QSPE's is not expected to address this Issue and, therefore, the FASB staff will bring this Issue to the Agenda Committee at a future meeting to determine whether to begin discussions on this Issue or to request that the Task Force remove this Issue from the agenda.	Future Agenda Committee or EITF Meeting
06-12	Accounting for Physical Commodity Inventories for Entities within the Scope of the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*	8/06	11/06	Not scheduled	Fanzini/ TBD	Pending the outcome of the Board's project to amend ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*.	Future EITF Meeting

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	TBD	Statement 155 did not address this Issue. Therefore, the FASB staff will bring this Issue to the Agenda Committee at a future meeting to determine whether to begin discussions on this Issue.	Future Agenda Committee