

**Emerging Issues Task Force
Agenda Committee Report
January 10, 2008**

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Emerging Issues Task Force Agenda Committee Decisions on Proposed Issues

1. Accounting for Share-Based Payment Transactions with Nonemployees

Background

At the October 15, 2007 Agenda Committee meeting, the Committee was asked to consider whether to add an issue to the EITF agenda regarding the determination of the measurement date for equity instruments that are issued to other than employees for acquiring, or in conjunction with selling, goods or services. That potential issue was considered by the Agenda Committee as the result of an agenda request regarding the criteria for determining the measurement date approach for instruments issued to nonemployees who have exclusivity arrangements with the issuer. The request asked that the Task Force develop factors that entities should consider when evaluating whether a performance commitment exists for exclusive independent contractor relationships.

The Agenda Committee deferred making a decision on whether to add this potential issue to the EITF agenda pending further research by the FASB staff on convergence opportunities involving FASB Statement No. 123 (revised 2004) *Share-Based payment*, EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring or in Conjunction with Selling, Goods or Services," and International Financial Reporting Standards 2, *Share-based Payment*. The results of the staff's research on the differences between accounting for nonemployee share-based payment transactions under U.S. GAAP and IFRS are discussed below.

**ACCOUNTING FOR NONEMPLOYEE SHARE-BASED PAYMENT TRANSACTIONS
SUMMARY OF PRIMARY DIFFERENCES (U.S. GAAP AND IFRS)**

Topic	FAS 123(R) (employees)	Issue 96-18	IFRS 2	Implications
Scope / Definition of Employee	The definition of employee in the glossary of FAS 123(R) is based on common law.	Applies to share-based compensation to other than employees except lenders or investors who provide financing to the issuer.	Employees "and others providing similar services" ¹ use the modified grant-date approach. All others are nonemployees.	More transactions are accounted for using the modified grant-date model under IFRS than under U.S. GAAP. As a result, fewer transactions are considered nonemployee transactions outside the scope of the modified-grant date model under IFRS 2 than FAS 123(R).
Measurement basis – fair value (FV) of goods/services received or equity instruments	Transactions with employees are measured based on the FV of equity instrument. For nonemployees, measurement is based on whichever is more reliably measurable.	Scope of Issue 96-18 is limited to situations in which the equity instrument is more reliably measurable.	For employees and others providing similar services use FV of equity instrument granted. ² For others, IFRS 2 includes a rebuttable presumption that FV of goods or services can be estimated reliably. IFRIC 8 has been interpreted by some to require the FV of the equity instruments to be measured as well and accounting for any "excess FV" would also need to be accounted for as unidentifiable goods.	The basic difference between U.S. GAAP and IFRS in this area is whether or not there is a presumption as to the more readily measurable fair value. IFRS includes a presumption that the goods or services received are more readily measurable, but U.S. GAAP does not. Based on discussions with practitioners, many entities that apply IFRS either overcome the presumption, or they believe that IFRIC 8 requires measurement of the equity instrument.

¹ Defined in IFRS 2 as "Individuals who render personal services to the entity and either (a) the individuals are regarded as employees for legal or tax purposes, (b) the individuals work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes, or (c) the services rendered are similar to those rendered by employees. For example, the term encompasses all management personnel, i.e., those persons having authority and responsibility for planning, directing and controlling the activities of the entity, including non-executive directors."

² Paragraph 11 of IFRS 2 states that the fair value of the equity instrument granted should be used to measure the fair value of the services rendered by an employee or others providing similar services.

Topic	FAS 123(R) (employees)	Issue 96-18	IFRS 2	Implications
Measurement date	Grant date in most situations	Earlier of the date of a performance commitment ³ or the date the counterparty's performance is complete. The counterparty's performance is complete when it has delivered the goods or services required under the arrangement and, therefore, is entitled to keep or exercise the award. Performance is not complete if the awards are forfeitable in the event performance is not completed, such as when the award vests over the performance period of the award.	Grant date in most situations for employees and others providing similar services. For nonemployee awards, the date the entity obtains the goods or the counterparty renders service. If goods or services are received on more than one date, an entity should measure the fair value of the equity instruments on each date when goods or services are received. If services are received continuously, an entity could use an average price over the period in some situations.	Issue 96-18 and IFRS 2 both share the notion that there is a fundamental difference between the relationship between an entity and its employees and the relationship between an entity and non-employees. That is, the likelihood of a non-employee's performance is directly related to the value of the equity award, whereas an employee generally is dependent on the employer for reasons beyond the share-based compensation. Issue 96-18 addresses this difference through the notion of a performance commitment, as well as by measuring the goods when received or the services when performance is complete. IFRS 2 requires measurement when the goods are received or services rendered. The difference between the two is that IFRS 2 permits measurements prior to the ultimate completion (that is, as goods or services are received), whereas Issue 96-18 requires the ultimate measurement for the award to be at the ultimate completion of the required performance.

³ Defined in Issue 96-18 as "...a commitment under which performance by the counterparty to earn the equity instruments is probable because of sufficiently large disincentives for nonperformance. The disincentives must result from the relationship between the issuer and the counterparty. Forfeiture of the equity instruments as the sole remedy in the event of the counterparty's nonperformance is not considered a sufficiently large disincentive for purposes of applying this guidance. In addition, the ability to sue for nonperformance in and of itself, does not represent a sufficiently large disincentive to ensure that performance is probable. (The Task Force observed that an entity can always sue for nonperformance but that it is not always clear whether any significant damages would result.)"

Topic	FAS 123(R) (employees)	Issue 96-18	IFRS 2	Implications
Measurement effect of performance condition	Interim measurement is based on the probable outcome of the performance condition. Ultimate measurement is based on the actual outcome of the performance condition.	Use the lowest aggregate amount within the range of potential values for measurement and recognition purposes, which could be zero. Use modification accounting after the measurement date.	Essentially the same as FAS 123(R) with no distinction between employee and nonemployee.	A significant difference exists between the accounting for performance conditions for employees and those for nonemployees in U.S. GAAP based on the differences between FAS 123 (R) and Issue 96-18. For example, interim measurements of compensation cost for an award that vests only upon achievement of a performance condition that is considered probable would be based on the fair-value-based measure of the award under FAS 123(R), but would be measured at zero under Issue 96-18. There is no difference between employees and nonemployees in IFRS 2.
Measurement effect of market condition	Value of the market condition is included in the value of the award. Expense is recognized if the requisite service is rendered.	Similar to the approach in FAS 123(R). After performance is complete, guidance in other literature on financial instruments (for example, Issue 00-19) would apply for any changes.	Essentially the same as FAS 123(R) with no distinction between employee and non-employee.	Market conditions impact the FV measurement of the awards for employees and nonemployees under all literature.

If the Agenda Committee decides to add an issue to the EITF agenda to reconsider the guidance for nonemployee share-based payment transactions with the intention of converging the accounting literature, the staff has identified two ways in which the scope of that issue may be characterized:

- a. To simplify the accounting for employees and nonemployees under U.S. GAAP by interpreting the scope of Statement 123(R) to include a converged definition of employee (by including those providing similar services within its scope) and to converge the accounting for those not meeting the revised definition of employee.
- b. To resolve each of the differences between Statement 123(R), Issue 96-18, and IFRS 2 on an individual basis.

Consistent with Issue 96-18, this potential issue does not address the accounting for equity instruments issued either (a) to a lender or an investor who provides financing to the issuer or (b) in a business combination.

Accounting Issue and Alternatives

Whether the accounting model for nonemployee share-based payment transactions should be reconsidered.

View A: The Task Force should nullify Issue 96-18 and develop a new model for accounting for individuals who provide services similar to those provided by employees consistent with Statement 123(R) and adopt the IFRS 2 approach for accounting for nonemployee share-based payment transactions.

Under View A, the modified grant-date model in Statement 123(R) and IFRS 2 would be applied to employees and "others providing similar services." View A proponents believe that applying the modified grant date model to awards to nonemployees providing services similar to those of employees would be more consistent with the boards' bases for their respective conclusions that the use of the modified-grant date model is appropriate for certain grants based on the nature of

the relationship between the grantee and the grantor. For example, the performance of an independent contractor providing full time services similar to those provided by employees is not solely dependent on the value of the equity instruments. Further, in such situations, determining whether the grantee qualifies as a common law employee is highly subjective, and the approach under IFRS 2 largely eliminates the need for these more subjective determinations. For nonemployees under the revised definition (that is, those who are **not** providing services similar to the services provided by employees), the guidance could converge to the IFRS 2 approach. Under the IFRS 2 approach, there would be a rebuttable presumption that the fair value of the goods or services would be more readily measurable than the fair value of equity instruments, and the fair value would be measured at the date that the entity obtains the goods or the counterparty renders service, subject to the considerations in International Financial Reporting Interpretations Committee, Interpretation 8, *Scope of IFRS 2*. Other areas, such as the effect of performance and market conditions, would be accounted for consistent with Statement 123(R) and IFRS 2.

Proponents of View A believe that the Task Force should adopt the IFRS accounting model for nonemployee share-based payment transactions in order to reduce the unnecessary complexity in this area, as well as to promote similar accounting for similar transactions. Currently, there are significant differences in the accounting for certain aspects of employee and nonemployee share-based payment awards without any apparent underlying conceptual basis for the differences. In addition, proponents of View A believe that the consensus in Issue 96-18 is overly complex as illustrated by the relatively large number of examples (14) necessary to illustrate its provisions.

Opponents of View A assert that Issue 96-18 was developed in response to problems that arose with accounting for share-based payments to nonemployees. Those opponents acknowledge that Issue 96-18 is a model that was developed in response to some of the concerns at the time and contains guidance that is designed to prevent abuse. Furthermore, those opponents note that the Board decided not to address those issues in the development of both Statement 123 and Statement 123(R) but to address those concerns in a separate project. That project is on hold pending further development of the Board's liabilities and equities project. Accordingly,

opponents are concerned with the Task Force initiating a project on this topic without fully analyzing the accounting consequences of adopting guidance contained in IFRS 2.

View B: The Task Force should not adopt the provisions of IFRS 2 as a whole, but rather should examine various alternatives among the differences between IFRS 2 and Issue 96-18, as outlined below.

Proponents of View B believe that there is significant room for improvement in the accounting model for nonemployee share-based payment transactions in U.S. GAAP, and aligning the accounting with Statement 123(R) and IFRS 2 would be an improvement. However, proponents of View B believe that not all aspects of IFRS 2's accounting in this area are preferable or compatible with existing U.S. standards. For example, U.S. GAAP currently has a definition of employee in Statement 123(R) that has been used in practice since the 2000 issuance of FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*. Constituents are familiar with that definition, and proponents of View B do not believe that the IFRS 2 notion would necessarily be an improvement in U.S. financial reporting.

Proponents of View B think that the Task Force should analyze the existing differences between the accounting models individually prior to concluding on a particular model. Those considerations would include the following:

- a. The definition of employee for purposes of Statement 123(R). Should Statement 123(R) incorporate "others providing similar services," as defined in IFRS 2?*
- b. The measurement date of awards granted to nonemployees. Should the grant date, the date that the goods are provided or services are rendered, or the earlier of the commitment date or date services are rendered, be used to measure awards?*
- c. The measurement basis of share-based transactions. Should transaction be measured at the fair value of the service provided or goods delivered, the fair value of the equity instrument issued, or some other amount?*

- d. *The measurement effect of performance conditions. How should performance conditions impact the recognition of compensation cost prior to the measurement date of the equity instrument issued?*
- e. *Whether the accounting guidance for the recipient of the awards (for example, EITF Issues No. 00-8, "Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services," and No. 00-18 "Accounting Recognition for Certain Transactions involving Equity Instruments Granted to Other Than Employees") would need to be readdressed?*

Some opponents of View B are concerned with the Task Force taking on such a broad reconsideration of the accounting for share-based payments to non-employees and prefer that the Board retain its original plan to reconsider that accounting guidance upon further development of the Board's liabilities and equity project. Other opponents of View B believe that the EITF should emphasize convergence (that is, View A) in its deliberations of this potential issue.

The analysis under View B did not attempt to consider all of the potential alternatives to the questions presented. Furthermore, while the analysis attempted to identify all significant differences between current U.S. GAAP and IFRS with respect to nonemployee share-based payment transactions, the staff may identify additional individual differences if the Agenda Committee adds this item to the EITF agenda.

Agenda Committee Decision: *The Agenda Committee decided not to add this issue to the EITF agenda.*

2. Consideration of Conforming Changes to Issue 98-5 and Tentative Conclusions in Issue 00-27

Background

EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," was intended to clarify certain aspects of EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios." Certain consensuses in Issue 00-27 superseded portions of Issue 98-5. The status section in Issue 98-5 refers to the guidance in Issue 00-27, as well as the transition provisions for that guidance. However, the portions of Issue 98-5 that were nullified by the consensuses in Issue 00-27 were not specifically identified in the abstract for Issue 98-5, nor were the illustrative examples in Issue 98-5 updated for the effects of the consensuses in Issue 00-27.

FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, was issued in May 2003. Instruments within the scope of Statement 150 are accounted for pursuant to the guidance in that Statement and are not within the scope of Issues 98-5 and 00-27. However, discussion of Statement 150 was not included in the Status section of Issue 98-5.

The FASB staff was informed by a constituent that some issuers were continuing to follow the guidance in Issue 98-5 that had been nullified by either Issue 00-27 or Statement 150. That constituent requested that the FASB staff eliminate the nullified guidance from Issue 98-5 and incorporate appropriate references to the current guidance. The FASB staff agreed with that request and, at the November 29, 2007 EITF meeting, proposed to (a) replace the superseded guidance in Issue 98-5 with the current guidance in Issue 00-27, (b) update the illustrative examples in Issue 98-5 to reflect the current guidance in Issue 00-27, (c) add a status update discussion in Issue 98-5 relating to Statement 150, (d) delete the illustrative examples in Issue 98-5 that are within the scope of Statement 150, and (e) delete an illustrative example in Issue 98-5 that requires interpretations of various pieces of subsequently issued accounting literature that are not currently reflected in that example.

Certain Task Force members noted concerns with the format of the changes and asked the staff to consider modifications to Issue 98-5 that would (a) retain the nullified guidance, noting that such guidance applies to instruments with a commitment date that occurred prior to November 16, 2000, and (b) incorporate the current guidance into the abstract and examples. The revised, proposed clarifications to Issue 98-5 will be presented to the Task Force at the next EITF meeting.

Some Task Force members observed that there is a related dormant item on the EITF agenda regarding Issue 00-27 and suggested that the Task Force consider deliberating the remaining open issues for which tentative conclusions were previously reached. Other Task Force members asserted that the complexity associated with the guidance in Issues 98-5 and 00-27 would be reduced if those two Issues were codified into a single EITF abstract. Accordingly, the Task Force requested that the Agenda Committee consider:

- a. Whether further clarification to Issue 98-5 is needed regarding its applicability to features that provide for a fixed payoff, which may be settled in shares, if the instrument is not within the scope of Statement 150.
- b. Whether transition guidance for any clarifications to Issue 98-5 is needed.
- c. Whether the Task Force should consider the dormant issues from Issue 00-27.
- d. Whether Issues 98-5 and 00-27 should be codified into a single EITF abstract.

Background on Issues 98-5 and 00-27, and Statement 150

Issue 98-5

Issue 98-5 addresses (a) the accounting for convertible debt instruments and convertible preferred stock with nondetachable conversion features that are in-the-money at the commitment date and (b) an issuer's accounting for convertible instruments that have conversion prices that are variable based on future events.

Issue 00-27

Subsequent to the consensus on Issue 98-5, a number of application issues about the Issue 98-5 model were raised. Consequently, a project was added to address certain practice issues resulting from application of the Issue 98-5 model and, in the event those issues could not be adequately addressed within the existing framework, to consider a different model. A Working Group was also formed. At the November 15–16, 2000 EITF meeting, the Task Force reached a consensus on Issue 00-27 to maintain the existing Issue 98-5 framework (Part I of Issue 00-27). At that meeting, the Task Force also reached 10 additional consensuses on application issues relating to the Issue 98-5 framework (Part II of Issue 00-27).¹ Certain of those consensuses (Issues 4 and 6) superseded portions of the guidance in Issue 98-5 and affected the illustrative examples in that Issue. At the November 15–16, 2000 EITF meeting, the Task Force also reached three tentative conclusions (Issues 12(a), 12(b), and 12(c)).

Subsequent to that meeting, the Working Group met and recommended that the Task Force make all of its conclusions on the additional issues tentative until the Working Group and the FASB staff codified the model in Issue 98-5 and the guidance in Issue 00-27. At the January 17–18, 2001 EITF meeting, as recommended by the Working Group, the Task Force reached tentative conclusions on most of the additional issues and requested that the FASB staff codify the consensuses and tentative conclusions in Issues 98-5 and 00-27 into a single EITF abstract.²

On March 19, 2001, the Working Group held its third meeting to discuss the codified abstract prepared by the FASB staff. However, during that meeting, the Working Group and FASB staff determined that (a) further discussion of the application issues for which the Task Force had not reached a final consensus in Issue 00-27 and (b) codification of Issues 98-5 and 00-27 into a

¹ At the November 15–16, 2000 EITF meeting, consensuses were reached on Issues 1–8, 10, and 11 of Issue 00-27. The Task Force decided that Issue 9 should be addressed as a separate EITF Issue and it was removed from Issue 00-27.

² At the January 17–18, 2001 EITF meeting, tentative conclusions were reached on Issues 13(a), 13(b), 13(c), 14, 15, and 16(b). The Task Force reaffirmed its tentative conclusions on Issues 12(a) and 12(b) from the November 15–16, 2000 EITF meeting, but was not asked to reach a final consensus on those Issues. The Task Force also discussed the tentative conclusion previously reached on Issue 12(c) and reached a different tentative conclusion. The Task Force did not reach a tentative conclusion on Issue 16(a), regarding the need for specific presentation and disclosure requirements for convertible instruments subject to Issues 98-5 and 00-27. However, the Task Force did observe that FASB Statements Nos. 128, *Earnings per Share*, and 129, *Disclosure of Information about Capital Structure*, set forth disclosure requirements that apply to all convertible instruments.

single EITF abstract should cease pending developments on the Board's liabilities and equity project. No further discussion was held by the Task Force.

As a result of the decision not to proceed further with Issue 00-27, that Issue contains final consensuses on 10 application issues and tentative conclusions on 9 additional application issues (including sub-issues).

As stated above, as a result of the consensuses in Issue 00-27, a general status update was added to Issue 98-5. However, the portions of Issue 98-5 that were nullified by the consensuses in Issue 00-27 were not specifically identified in the abstract for Issue 98-5, nor were the illustrative examples in Issue 98-5 updated for the effects of the consensuses in Issue 00-27.

Statement 150

At the time Statement 150 was issued (May 2003), 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, even though instruments within the scope of Statement 150 are no longer within the scope of Issue 98-5 and certain of the illustrative examples in Issue 98-5 were nullified by that Statement.

Accounting Issues and Alternatives

Issue 1: Whether further clarification to Issue 98-5 is needed regarding its applicability to features that provide for a fixed payoff, which may be settled in shares, if the instrument is not within the scope of Statement 150.

At the November 29, 2007 EITF meeting, the FASB staff presented the following clarification to Issue 98-5 to reflect the effect of Statement 150:

24. 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).

25. A financial instrument that is convertible into a variable number of shares based solely or predominantly on a fixed monetary amount (that is, stock-settled debt) is within the scope of Statement 150. **A provision in a financial instrument that requires (or permits at the issuer's discretion) settlement by issuance of a variable number of shares that have a value equal to a fixed monetary amount is not a conversion option for purposes of applying Issue 98-5. Rather, such provisions should be evaluated as redemption features under other applicable guidance (for example, Statement 150, Statement 133, and Opinion 21).** [Emphasis added.]

At that meeting, some Task Force members observed that the language in the last two sentences of paragraph 25 was not limited to instruments within the scope of Statement 150. Financial instruments with a conversion feature that requires settlement through the issuance of a variable number of equity shares equal to a fixed monetary value are within the scope of Statement 150, paragraph 12(a). However, certain financial instruments have terms that provide for settlement through the issuance of (a) a variable number of shares if the share price is less than a certain amount, or (b) a fixed number of shares if the share price is equal to or greater than that amount. Such a financial instrument provides the holder with a guaranteed minimum value upon settlement and allows the holder to participate in the upside return as the number of shares to be received is fixed upon meeting the share price threshold. Those instruments are often economically equivalent to convertible debt issued at a discount, except that shares are issued at settlement regardless of whether the conversion feature is in-the-money. Case 1(d) of Issue 98-5 provides an illustrative example of such an instrument.

If, at inception, the monetary value of such an instrument is not *predominantly* based on a fixed monetary amount, the instrument would not be within the scope of paragraph 12 of Statement 150. Consequently, some Task Force members questioned whether proposed paragraph 25 goes beyond a status update of Issue 98-5 for the issuance of Statement 150 and actually provided new interpretive guidance. Comments were not received from Task Force members on paragraph 24.

An example of a financial instrument that contains a share settlement feature with a fixed payoff, but that may not be within the scope of paragraph 12 of Statement 150, is as follows:

Company A issues a convertible debt instrument for its par amount of \$1,000 that is "convertible" at any time through the life of the instrument. The share price at issuance is \$50 per share. The number of shares issuable at settlement is determined by dividing \$1,000 by the lower of (a) 80 percent of the issuer's stock price at the settlement date (resulting in a fixed payoff of \$1,250) or (b) \$40.

The following outcomes would occur under various share price scenarios:

Stock price at conversion date	25	30	40	50	60	70	80
80% of stock price at conversion date	20	24	32	40	48	56	64
Conversion Price (lesser of 80% of stock price or \$40)	20	24	32	40	40	40	40
# of shares received at conversion	50.0	41.7	31.3	25.0	25.0	25.0	25.0
Value of shares received at conversion	1,250	1,250	1,250	1,250	1,500	1,750	2,000

In this example, if the share price is between \$0.01 and \$50.00 the holder will receive a variable number of shares with a fair value of \$1,250 at settlement. Within that share price range, the payoff that the holder receives at settlement is unaffected by the issuer's share price. However, if the share price is more than \$50 upon settlement, the holder will convert into 25 shares and the payoff that the holder receives at settlement varies directly with changes in the issuer's share price.

View A: Include paragraph 25 in the Issue 98-5 status update.

In the above example, the issuer must first evaluate whether, at inception, the monetary value of the instrument is predominantly based on a fixed amount to determine whether the instrument is within the scope of Statement 150. If the issuer concludes that the instrument is not within the scope of Statement 150, the instrument would be evaluated as a convertible debt instrument with a conversion price of \$50, which is the price at which the holder begins to benefit from increases in the issuer's share price. For purposes of evaluating whether a beneficial conversion feature is

present, the issuer's stock price on the commitment date would be compared to the \$50 conversion price.

Proponents of this view believe that a provision of an instrument that would provide a fixed payoff to the holder should not be considered a conversion feature under the provisions of Issues 98-5 or 00-27. Conversely, such a provision should be evaluated as a redemption feature under other applicable accounting literature depending on its substance. For example, such features may be akin to put options subject to analysis under FASB Statement No. 133, *Accounting for Derivatives Instruments and Hedging Activities*, or they may represent the substantive principal amount of the instrument. Regardless of whether proposed paragraph 25 is included in the status update, the component of an instrument that provides for settlement in a fixed number of shares when the instrument is "in-the-money" would continue to be evaluated as a conversion option.

This view is further supported by language in Issue 00-27. Paragraph 13 in Issue 3 of Issue 00-27 states that

The Task Force noted that if a convertible instrument has a conversion option that continuously resets as the underlying stock price increases or decreases so as to provide a fixed value of common stock to the holder at any conversion date, the convertible instrument should be considered stock-settled debt and the contingent beneficial conversion option provisions of Issue 98-5 would not apply when those resets subsequently occurred. However, Issue 98-5 would apply to the initial accounting for the convertible instrument including any initial active beneficial conversion feature.

View A proponents believe that the final sentence of paragraph 13 regarding "initial active beneficial conversion features" was nullified by Statement 150. Those proponents refer to the status update in paragraph 64 of Issue 00-27, which states that

An instrument issued in the form of shares that is convertible into a variable number of shares based solely or predominantly on one of the conditions in paragraph 12 of Statement 150... is a liability under Statement 150, paragraph 12, because it is an outstanding share that embodies an unconditional obligation to be redeemed. **It is no longer in the scope of Issue 00-27.** [Emphasis added.]

Proponents of this view believe that these two paragraphs provide guidance consistent with the wording proposed in paragraph 25. That is, an instrument that includes a provision that requires (or permits at the issuer's discretion) settlement by issuance of a variable number of shares that have a value equal to a fixed monetary amount is not a conversion option for purposes of applying Issue 98-5.

View B: Exclude paragraph 25 from the Issue 98-5 status update.

The issuer must first evaluate whether, at inception, the monetary value of the instrument is predominantly based on a fixed amount, to determine whether the instrument is within the scope of Statement 150. If the issuer concludes that the instrument is not within the scope of Statement 150, the instrument could be evaluated in either of the following ways under View B:

- a. As a convertible debt instrument with a conversion price of \$50, which is the price at which the holder begins to benefit from increases in the issuer's share price. For purposes of evaluating whether a beneficial conversion feature is present, the issuer's stock price on the commitment date would be compared to the \$50 conversion price. This is the same analysis as would be performed under View A.
- b. As a convertible debt instrument with a conversion option that varies when the issuer's stock price is between \$0.01 and \$50. If the conversion option contains all the characteristics of a derivative instrument in paragraphs 6 – 9 of Statement 133, the issuer would likely conclude that the conversion option is not indexed to the Company's own stock because of the continuously resetting conversion rate and separate accounting for the conversion option as a derivative would be required. However, if the conversion option does not contain all of the characteristics of a derivative instrument under Statement 133, the instrument contains a beneficial conversion feature that must be allocated to additional paid-in capital. If the issuer's stock price is \$50 or less at issuance, that beneficial conversion feature is \$250,000, calculated as the difference between the initial conversion price and the fair value of the shares into which the debt is convertible, multiplied by the number of shares into which the debt is convertible.

Proponents of this view believe that the status section of Issue 98-5 should state that if an instrument is within the scope of Statement 150, the guidance in Issue 98-5 would not apply. Proponents believe that the guidance in proposed paragraph 25 provides interpretative guidance, which is beyond the scope of making conforming changes.

Note: If this issue is added to the EITF's agenda, the FASB staff recommends that this issue only address providing a status update in Issue 98-5 and not broadly address the accounting treatment for instruments with such settlement features. Additionally, the results from not adding this issue to the EITF's agenda will be the same as View B, as no guidance for instruments with provisions that require (or permit at the issuer's discretion) settlement by issuance of a variable number of shares that have a value equal to a fixed monetary amount will be provided in Issue 98-5.

Issue 2: Whether transition guidance in Issue 98-5 is needed.

View A: Provide transition guidance for all conforming changes made to Issue 98-5.

There have been instances in practice to which preparers have applied the guidance in Issue 98-5 without consideration of Issue 00-27 and Statement 150. Although application of Issue 98-5 without the consideration of Issue 00-27 and Statement 150 may produce an error, some believe that transition guidance for such transactions is necessary because Issue 98-5 was not properly amended for the issuance of these two standards. For example, the examples in Issue 98-5 that were clearly affected by the subsequent guidance were never updated to reflect their impact.

Additionally, the Status section of Issue 98-5 contains only a brief discussion of the impact of Issue 00-27 and contains no discussion of Statement 150. The discussion of Issue 00-27 is limited to when Issue 00-27 is applicable and does not discuss how the guidance affects Issue 98-5.

View B: Provide transition guidance only for changes made in relation to proposed paragraph 25, depending on the ultimate outcome of Issue 1.

The Status section of Issue 98-5 discusses Issue 00-27 in the context of when Issue 00-27 is effective. However, the status section of Issue 98-5 does not contain any discussion of Statement 150. Proponents of View B believe that transition guidance should be provided solely for transactions affected by the inclusion of a discussion of Statement 150 in the Status section of Issue 98-5 as this is a newly added item. Conversely, no transition guidance should be given for the conforming changes made relating to Issue 00-27 as discussion of Issue 00-27 has always existed in the Status section of Issue 98-5, albeit limited.

View C: Provide no transition guidance.

As the Status section of Issue 98-5 includes discussion of Issue 00-27, a preparer was provided with the appropriate amount of information to know that Issue 00-27 was effective and should be followed. Therefore, no transition guidance relating to the Issue 98-5 conforming changes should be provided.

In regards to the Statement 150 conforming changes, although no reference to Statement 150 was included in the Status section of Issue 98-5, Statement 150 is a higher level of authoritative literature. As such, preparers should have used the higher level of authoritative literature when determining the appropriate accounting for such transactions. Therefore, no transition guidance should be provided for these conforming changes.

Issue 3: Whether the Task Force should consider the dormant tentative conclusions in Issue 00-27.

As stated above, the Task Force reached tentative conclusions on certain issues and requested that the FASB staff codify all of the consensuses and tentative conclusions reached in Issues 98-5 and 00-27 into one EITF abstract prior to finalizing such conclusions. The working group subsequently determined that further discussion of unresolved issues, the 9 tentative conclusions and the codification of Issues 98-5 and 00-27 should cease pending developments on the Board's liabilities and equity project.

Issue 00-27 was issued with 10 final consensuses on application issues and tentative conclusions on 9 additional application issues (including sub-issues). The open issues in Issue 00-27 are the following:

Issue 12 If a convertible instrument that included a beneficial conversion option under Issue 98-5 is extinguished prior to its stated maturity date, how Issue 98-5 should be applied to the reacquisition of the embedded conversion option.

Issue 12(a) Whether it is appropriate to allocate a portion of the reacquisition price to the conversion option based on the intrinsic value of that option at the extinguishment date if no separate accounting for the conversion option under Issue 98-5 has occurred.

Issue 12(b) How the requirement to allocate a portion of the reacquisition price to the beneficial conversion option for convertible debt should be applied if the intrinsic value of that option at the date of extinguishment is greater than the originally measured intrinsic value.

Issue 12(c) Whether it is ever appropriate to allocate a portion of the reacquisition price to an embedded beneficial conversion option on the issuer's common stock upon the early redemption of convertible preferred stock.

Issue 13 A company issues a warrant that allows the holder to acquire a convertible instrument for a stated exercise price. The warrant provides only for physical settlement (that is, delivery of the convertible instrument in exchange for the stated exercise price) and is classified as an equity instrument (either temporary or permanent). The issue is how to measure and when to recognize a beneficial conversion option in the underlying warrant.

Issue 13(a) Whether the commitment date for purposes of measuring the intrinsic value of the conversion option in the convertible instrument that is the underlying for the warrant is (a) the commitment date for the warrant or (b) the exercise date of the warrant.

Issue 13(b) When measuring the intrinsic value of a conversion option embedded in a convertible instrument that is the underlying for the warrant, how the deemed proceeds for the convertible instrument should be computed.

Issue 13(c) Whether the measured intrinsic value of a beneficial conversion option in a convertible instrument that is the underlying for the warrant should be recognized at the date the warrant is issued or at the date the warrant is exercised and the convertible instrument is issued.

- Issue 14* A company issues a warrant that allows the holder to acquire a convertible instrument for a stated exercise price. The warrant provides only for physical settlement (that is, delivery of the convertible instrument in exchange for the stated exercise price) and is classified as a liability instrument. The issues are (1) whether the commitment date for purposes of measuring the intrinsic value of a conversion option in a convertible instrument that is the underlying for a warrant is (a) the commitment date for the warrant or (b) the exercise date of the warrant, (2) how the deemed proceeds for the convertible instrument should be computed, and (3) when the intrinsic value of a beneficial conversion option in the underlying convertible instrument should be recognized.
- Issue 15* How a beneficial conversion amount should be measured when an entity issues a convertible instrument that, if converted, will result in the holder receiving common stock and other equity instruments of the issuer, such as warrants to acquire common stock of the issuer.
- Issue 16(a)* Whether there should be specific presentation or disclosure requirements for convertible instruments subject to Issue 98-5 (as interpreted by Issue 00-27).
- Issue 16(b)* Whether a convertible preferred stock that has a conversion option within the scope of the Issue 98-5 model (as interpreted by Issue 00-27) should be classified as either permanent or temporary equity using the guidance in Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

View A: The Task Force **should** consider the dormant tentative conclusions in Issue 00-27.

View A proponents observe that the nine tentative conclusions have not been discussed by the Task Force for seven years. Those proponents believe that such tentative conclusions have been treated as authoritative GAAP by practitioners when evaluating the accounting for such transactions. Therefore, View A proponents believe that the Task Force should provide formal guidance in that area, noting that such guidance would otherwise be eliminated when the FASB Codification project is completed.

*View B: The Task Force **should not** consider the dormant tentative conclusions in Issue 00-27.*

In November 2007, the FASB issued a Preliminary Views Document on Financial Instruments with Characteristics of Equity (the PV). The PV discusses three approaches for distinguishing between equity and liabilities and assets (basic ownership, ownership-settlement, and reassessed expected outcome). Regardless of the approach reached in the final standard, the end product is expected to be one comprehensive standard that addresses accounting for financial instruments with characteristics of equity. Upon issuance of a final standard in the FASB liabilities and equity project, both Issue 98-5 and Issue 00-27 will be nullified in their entirety.

Proponents of View B believe that the open items in Issue 00-27 should be removed from the EITF agenda because it will likely take extensive time to redeliberate those issues and reach conclusions that will shortly thereafter be nullified by the issuance of a final standard on Financial Instruments with Characteristics of Liabilities and Equity. As such, resources of both the FASB and the EITF could be allocated to projects that would have a lasting effect.

In addition, the FASB has not received technical inquiries relating to the tentative conclusions reached in Issue 00-27. It is the FASB staff's understanding that there is currently limited diversity in practice regarding the tentative conclusions. Although the conclusions are tentative, as there is no other authoritative literature around these issues, reporting entities have looked to these tentative conclusions for guidance. Furthermore, it is the staff's understanding that there are relatively few transactions entered into currently to which the issues would apply.

Many constituents have indicated that the preponderance of rules with respect to financial instruments with characteristics of liabilities and equity has caused significant difficulties in practice. In many cases, such criticisms are targeted at the detailed guidance on beneficial conversion features that is already contained in Issues 98-5 and 00-27. View B proponents do not support expanding the already complex guidance on accounting for beneficial conversion features by adding new rules at this point.

Issue 4: Whether Issues 98-5 and 00-27 should be codified into one EITF abstract.

At the November 2007 EITF meeting, certain Task Force members questioned whether a project to codify Issues 98-5 and 00-27 into a single EITF abstract should be added to the EITF agenda.

*View A: Issues 98-5 and 00-27 **should** be codified into a single EITF abstract by the Task Force, separate and apart from the FASB Codification project.*

View A proponents believe that the codification of Issues 98-5 and 00-27 into a single Issue would reduce complexity for preparers and auditors because the guidance on accounting for beneficial conversion features would be contained in one EITF abstract instead of two.

*View B: Issues 98-5 and 00-27 **should not** be codified into a single EITF abstract by the Task Force.*

The current and ongoing FASB Codification project will codify all authoritative accounting literature. The Codification project is on target with its plan for the early-2008 release of the FASB Codification for verification by constituents. This project will not only codify Issues 98-5 and 00-27, but all of the accounting literature relating to convertible instruments.

The FASB Codification Team has already performed the initial work relating to the codification of all accounting guidance on convertible debt, including the guidance in Issues 98-5 and 00-27. View B proponents believe, based on the difficulties encountered by the Working Group when it attempted to codify Issues 98-5 and 00-27 in 2001, that such an effort would likely take multiple meetings to complete. Additionally, when the codification was attempted by the FASB staff and the Working Group members in early 2001, it was decided that such codification would be an exhaustive effort not worthy of completion based on the fact that there was an ongoing FASB project that would affect the beneficial conversion feature guidance. It should also be noted that when attempting to codify the two EITF Issues, the FASB staff identified multiple issues that would require consideration by the EITF.

View B proponents believe that there is no benefit to be derived from the Task Force engaging in a parallel codification effort that will be completed **after** the more comprehensive codification work for all accounting guidance on convertible debt. Also, given the multiple other pieces of accounting literature that need to be considered in evaluating the accounting for convertible instruments, including convertible instruments that are potentially subject to Issues 98-5 and 00-27,³ View B proponents believe that no substantive reduction in complexity would occur by combining Issues 98-5 and 00-27 into a single issue. In addition, View B proponents observe that the concept of beneficial conversion features is not being considered under any of the three alternative approaches that are being considered through the Board's liabilities and equity project, the guidance in Issues 98-5 and 00-27 is expected to be nullified by the issuance of a final standard resulting from that project.

Agenda Committee Decision: *The Agenda Committee agreed to add Issues 1 and 2 of this issue to the EITF agenda. The Agenda Committee decided to recommend that the Task Force remove Issues 3 and 4 of this issue from the EITF agenda.*

³ Such other literature that needs to be considered in determining the appropriate accounting and disclosures for convertible instruments includes, but is not limited to, FASB Statements Nos. 84, *Induced Conversions of Convertible Debt*, 128, *Earnings per Share*, 129, *Disclosure of Information about Capital Structure*, 133, *Accounting for Derivative Instruments and Hedging Activities*, and 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*; APB Opinions Nos. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*, 21, *Interest on Receivables and Payables*, and 26, *Early Extinguishment of Debt*; AICPA Accounting Interpretation, "Early Extinguishment of Debt," of APB Opinion No. 26; EITF Issues No. 90-19, "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion," No. 96-19, "Debtor's Accounting for a Substantive Modification or Exchange of Debt Instruments," No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock,'" No. 03-7, "Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of EITF Issue No. 90-19)," No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share," No. 05-1, "Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option," No. 05-2, "The Meaning of 'Conventional Convertible Debt Instrument' in EITF Issue No. 00-19," No. 06-6, Application of EITF Issue No. 05-7," and No. 06-7, "Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133," and *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."

3. Determining Whether a Money Market Mutual Fund is Designed to Create and Pass Along Interest Rate Risk for Purposes of Applying Interpretation 46(R)

Background

A typical regulated money market mutual fund (MMF or Fund) is a type of mutual fund that is regulated primarily under the Investment Company Act of 1940 (the 1940 Act) and the rules adopted under the 1940 Act, particularly Rule 2a-7. Among other requirements, Rule 2a-7 of the 1940 Act requires that a regulated MMF:

- Invest in either Tier 1 or Tier 2 securities with a remaining maturity of 397 days or less¹
- Maintain an average dollar-weighted maturity of 90 days or less
- Invest no more than 5 percent of total assets in the same issuer and no more than 1 percent of total assets in any Tier 2 security
- Establish a board of directors that elects the investment advisor and is controlled by the Fund's shareholders.

Further, although not required by regulation, it is often the case that the shares issued by MMFs are typically widely dispersed across multiple investors such that no single investor would hold a significant portion of an MMF's outstanding shares.

Given the above requirements, MMFs generally invest in short term government securities, certificates of deposit, and commercial paper and pay dividends that generally reflect short-term interest rates. While an MMF's return to investors may fluctuate as general interest rates fluctuate, the requirements of Rule 2a-7 are designed to minimize the credit risk of an MMF's underlying asset portfolio. Thus, although credit losses in the underlying portfolio are possible, regulated MMFs are typically managed with the goal of keeping such losses to a minimum. Rule 2a-7 allows regulated MMFs to keep their reported net asset value (NAV) at \$1.00 per share

¹ Tier 1 and Tier 2 correspond to the highest ratings ("1" or "2") for short-term obligations by SEC recognized rating agencies.

unless the amortized cost of the portfolio deviates by more than 0.5 percent from market value.² As of December 12, 2007, MMFs held roughly \$3.1 trillion dollars of assets.³

In an effort to increase yield, some MMFs have invested in highly-rated short-term debt issued by structured investment vehicles (SIVs). (SIVs issue short-term debt to buy higher yielding securities.) In recent months, certain SIVs have experienced significant losses as a result of the turmoil in the credit markets, with such losses leading to subsequent rating agency downgrades of SIV securities. In some instances, the realized (or in the event of downgraded but non-defaulted securities, the unrealized) losses associated with SIV securities have raised the possibility that MMFs holding such securities may be forced to report an NAV of less than \$1.00. This is commonly referred to as "breaking the buck." In order to avoid having Funds under their management break the buck, certain sponsors of MMFs (who are also the Funds' advisors) may provide support to the MMFs, which may include, but is not necessarily limited to, capital contributions, standby letters of credit, guarantees of principal and interest, and agreements to purchase troubled securities at par. In essentially all instances, the provision of such support is not contractually required and is at the sole discretion of the sponsor.

The recent actions of MMF sponsors, as described above, raise several questions in the application of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, by a sponsor to its interest in an MMF, including: whether an implicit variable interest exists,⁴ whether the act of providing support constitutes a reconsideration event under paragraph 7, and whether the Fund is a VIE. The answer to each of those questions will largely be driven by the individual facts and circumstances surrounding the Fund and thus, while important considerations, are outside of the scope of this agenda item.

² This discussion is limited to regulated MMFs, however we note that there is a population of unregulated MMFs that are designed and intended to operate to the same standards as regulated MMFs. We believe sponsors analyzing such unregulated Funds under the "by design" approach specified by FSP FIN 46R-6, would be forced to address questions similar to those raised in this agenda submission.

³ Source: Investment Company Institute (<http://www.ici.org>)

⁴ FASB Staff Position FIN 46(R)-5, "Implicit Variable Interests under FASB Interpretation No. 46(R)," discusses factors to consider in determining whether an implicit variable interest exists. Those factors include, but are not limited to, whether there is an economic incentive for the sponsor to act as a guarantor or to make funds available, whether such actions have happened in similar situations in the past, and whether the sponsor acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

If upon providing the support described above, it is determined that a **Fund is a VIE**, the threshold question that must be addressed is whether the Fund is designed to create and pass along interest rate risk to its interest holders. If one concludes interest rate risk *is not* a risk the Fund is designed to create and pass along to its interest holders, there may be instances, as described in the table below, in which a sponsor absorbs the majority of the expected losses and residual returns of the Fund being evaluated. In those instances, the sponsor, as primary beneficiary, would consolidate the Fund. On the other hand, if it is determined that interest rate risk *is* a risk that the Fund is designed to create and pass along to interest holders, it is likely that the Fund will have no primary beneficiary. This is due to the fact that interest rate risk will likely be present in each scenario that forms the basis of an expected loss calculation, whereas credit risk (that is, credit losses) will only be present in a smaller subset of the scenarios that form the basis of an expected loss calculation. Because interest rate risk will be absorbed by the widely dispersed shareholder population in every scenario, a qualitative analysis would likely lead to the conclusion that no single party would absorb a majority of the Fund's expected losses and/or expected residual returns. In contrast, credit risk will only be absorbed by the sponsor and depending on the level of support provided by the sponsor, possibly the shareholders in only a subset of scenarios; the sponsor would likely absorb a majority of the Fund's expected losses.

In short, this leads to the following outcomes being likely upon the completion of a consolidation analysis in the various scenarios discussed above:

	Consolidator of Voting Interest Entity	Consolidator of Variable Interest Entity (Credit + Interest Rate Risk)	Consolidator of Variable Interest Entity (Credit Risk Only)
Sponsor	No – No voting control	Not likely - Unless credit related variability is > interest rate variability and credit risk variability absorbed by the sponsor is > credit and interest rate risk absorbed by all other parties combined ⁵	Likely – Unless sponsor absorbs < 50% of credit related variability
Shareholders	No – Unless owns > 50% of MMF shares	Not likely – Unless owns > 50% of MMF shares	Not likely – Unless sponsor provides minimal credit support and single shareholder absorbs > 50% of total credit risk (which would entail single shareholder owning (possibly significantly) in excess of 50% MMF shares

If it is determined that a sponsor is the primary beneficiary, it is required to consolidate an MMF. The sponsor would bring 100 percent of the Fund's assets on to its consolidated financial statements. In many cases, because the sponsor has no equity interest in the Fund, it would also record a 100 percent minority interest.⁶ Further, as part of the consolidation process the sponsor would record the gross interest receipts on the Fund's assets as interest income, eliminate the management fee income received from the Fund, and record income attributable to minority

⁵ It is worth noting that the relative significance of interest rate risk in any expected loss calculation, will be determined (in part) by the manner in which one analyzes the variability of the entity (that is, does the enterprise making the evaluation use the "cash flow" or "fair value" approach to measuring variability.) Diversity in practice exists with regards to which method to use, and has been widely acknowledged by practitioners, the EITF (in deliberating EITF Issue No. 04-7, "Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity"), and the FASB staff (in deliberating FASB Staff Position FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)"), and thus is outside of the scope of this agenda paper.

⁶ In this case, the MMF's equity interests are not considered mandatorily redeemable under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*.

interest equal to 100 percent of the Fund's net income (loss) plus any credit support provided to the Fund by the sponsor. Some may question whether such a consolidated presentation is relevant to the investors, creditors, and other users of the sponsor's financial statements or whether the users might be better served by a "deconsolidated" view with adequate measurement and transparent disclosure of the support provided by the Fund sponsor.⁷

Analysis of MMFs under Interpretation 46(R)

Historically, MMFs have typically been considered voting interest entities because (1) the Fund was deemed to have sufficient equity investment at risk to finance its activities without additional subordinated financial support and (2) the Fund's group of at risk equity investors (that is, the MMF's shareholders) had the requisite characteristics of a controlling financial interest given the requirements that the MMF's shareholders have the ability to both (a) elect the MMF's board of directors and (b) approve the MMF's asset management agreements.⁸

Once a sponsor provides support to the MMF, the status of the Fund as a variable interest entity may require reconsideration.⁹ In many cases, the support provided by a sponsor protects the holders of equity at risk (that is, the shareholders) from the obligation to absorb the expected losses of the MMF associated with credit risk. If a reconsideration event has occurred, MMFs that were previously considered voting interest entities may now be considered variable interest entities that are subject to the consolidation provisions of Interpretation 46(R).¹⁰ If the MMF becomes a variable interest entity, each variable interest holder in the entity (including the

⁷ Such measurement and disclosure would likely result from application of derivative, financial guarantee, or contingent loss accounting, but that is outside of the scope of this potential new issue.

⁸ The sponsor is typically not considered a variable interest holder in the MMF at its inception because its interest in the Fund (by way of its advisor fee) meets the conditions in paragraph B18 – B22 of Interpretation 46(R).

⁹ Interpretation 46(R) requires that the initial determination of whether an entity is a variable interest entity be reconsidered if certain events occur. Specifically, paragraph 7(a) of Interpretation 46(R) provides that whether the entity is a variable interest entity must be reconsidered if "the entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the entity's equity investment at risk."

¹⁰ Under paragraph 5(a)(1) of Interpretation 46(R), an entity's equity at risk includes only investments in the entity that participate significantly in profits *and* losses. If a sponsor protects investors from the Fund's credit losses, the Fund's shareholders would be protected from losses of the Fund and, accordingly, their equity would not be deemed to be at risk. As a result, the Fund would not have any equity at risk thereby causing it to be a VIE. In addition, paragraph 5(b)(2) of Interpretation 46(R) states that an entity is a VIE if the group of equity-at-risk-investors does not have the obligation to absorb the expected losses of the entity and that "The investor or investors do not have the obligation if they are directly or indirectly protected from the expected losses or are guaranteed a return by the entity itself or by other parties involved with the entity."

sponsor) must determine whether it is considered the primary beneficiary. To make this determination, the variability that the MMF is designed to create and pass along to interest holders must be determined in order to isolate and identify the cash flows that would be included in a calculation of the MMF's expected losses.¹¹

FSP FIN 46(R)-6 addresses how a reporting enterprise should determine the variability to be considered in applying Interpretation 46(R). FSP FIN 46(R)-6 provides that this determination is based on an analysis of the design of the entity while considering (1) the nature of the risks in the entity¹² and (2) the purpose for which the entity was created and the variability (based on the risks identified in (1)) the entity is designed to create and pass along to interest holders.¹³

When analyzing an MMF in accordance with the provisions in FSP FIN 46(R)-6, practitioners generally identify (1) interest rate risk and (2) credit risk as the two main risks that warrant consideration as risks that the Fund might be designed to create and pass along.¹⁴ While practitioners agree that credit risk is a risk that all MMF's have been designed to create and pass along, diversity in practice exists regarding whether it is the design of the Fund to create interest rate risk and pass that risk along to interest holders. As previously outlined in the table above, because credit risk and interest rate risk are the only significant risk factors of an MMF and often the shareholders and sponsor (once support is provided) are the only variable interest holders, if interest rate risk is *not* considered a risk that an MMF is designed to create and pass along to interest holders, it is possible that the sponsor will be deemed the MMF's primary beneficiary because it may absorb a significant portion of the entity's credit risk through its explicit and/or implicit variable interests. In contrast, as explained earlier, if interest rate risk *is* considered a risk that an MMF is designed to create and pass along to interest holders, it is possible that

¹¹ It should be noted that once the risks that the entity was designed to create and pass along have been identified, it may be possible to identify whether an enterprise will absorb a majority of the expected losses of the MMF via a qualitative rather than a quantitative analysis.

¹² Paragraph 6 of FSP FIN 46(R)-6 states that "The risks to be considered in Step 1 that cause variability include, but are not limited to, the following: (a) credit risk, (b) interest rate risk (including prepayment risk), (c) foreign currency exchange risk, (d) commodity price risk, (e) equity price risk, and (f) operations risk."

¹³ Paragraph 7 of FSP FIN 46(R)-6 notes the following factors should be considered when determining the purposes for which an entity is created and the variability the entity is designed to create and pass along: "(a) the activities of the entity, (b) the terms of the contracts the entity has entered into, (c) the nature of the entity's interests issued, (d) how the entity's interests were negotiated with or marketed to potential investors, and (e) which parties participated significantly in the design or redesign of the entity."

¹⁴ Operations risk is also a risk of the MMF but is not considered significant to this analysis.

neither the sponsor nor any of the shareholders (whose holdings are often widely disbursed with no concentration held by any individual shareholder) would be the primary beneficiary, and therefore no enterprise would consolidate the Fund. It is for that reason that this agenda item focuses on the threshold question of whether interest rate risk should be included or excluded when analyzing the variability to which the interest holders in an MMF are exposed.

Accounting Issue and Alternatives

Whether interest rate risk is a risk that the MMF is designed to create and pass along to interest holders.

View A: Interest rate risk is not a risk that the MMF is designed to create and pass along to interest holders.

Proponents of View A believe that an MMF is effectively a pass-through entity. That is, the variability associated with reinvestment risk (or the variability in interest receipts on a variable rate investment¹⁵) exposes the Fund to variability in general market interest rates that is directly passed through to investors (less certain Fund expenses). The direct pass through nature of the interests in the entity results in investors in the Fund economically holding a variable rate interest in the entity.

Proponents of View A state that practice has been to not consider interest rate risk that arises from general market conditions as a source of variability because the entity is not *creating* interest rate risk but passing along general fluctuations in market interest rates. View A proponents believe that the exclusion of interest rate risk is supported by paragraph 12 of FSP FIN 46(R)-6, which provides, "periodic interest receipts/payments should be excluded from the variability to consider if the entity was not designed to create and pass along interest rate risk associated with such interest receipts/payments...." While FSP FIN 46(R)-6 does not explicitly state how to determine whether it is the design of an entity to create and pass along interest rate risk, it does provide examples of when it is clearly the design of an entity to create and pass

¹⁵ Although MMFs may hold fixed rate assets, as a result of the requirement that the MMF's assets have a dollar-weighted maturity of less than 90 days, the short term nature of the investment economically results in the MMF being exposed to general movements in interest rates as if the MMF held only variable rate investments.

along interest rate risk. These examples focus on scenarios in which it is the design of either the entity's activities or the interaction between the entity's assets and the interests the entity has issued to create: (1) variations in cash proceeds received upon the sale of fixed rate investments in an actively managed portfolio (or those held by a static pool that must be sold prior to maturity to satisfy the entity's obligations), (2) a mismatch in the asset and liability profile of the entity, or (3) both of the above.

In each of these scenarios, proponents of View A believe that FSP FIN 46(R)-6 establishes a general principle that both (a) broader market risks (for example, fluctuations in market interest rates or foreign currency rates) and (b) opportunity costs associated with investing in fixed or variable rate interests issued by the entity generally should not be viewed as creators of variability because these risks are not entity specific, but are instead part of the broader economic environment in which the entity operates. That is, it is not the entity's design to create these sources of variability. Rather, View A proponents believe that it is the interaction of the activities of the entity and the nature of the interests issued by the entity that are determinative as to whether interest rate risk is a source of variability the entity is designed to create and pass along to interest holders.

Based on the principle established in the FSP and the pass-through nature of the Fund, proponents of View A believe the MMF's activities (the equivalent of holding variable rate assets in a trust) and the nature of its interests issued (variable rate interests) do not **create** interest rate risk. In this case, the investors in an MMF are simply receiving a direct pass through of variability in general market interest rates that is not an entity specific risk or a risk that is created by the entity. Consistent with the examples in the FSP, proponents of View A believe that anytime either (a) the assets of the entity are not being actively traded such that it exposes the entity to interest rate risk associated with realized gains or losses or (b) there is not a mismatch between the assets and interests issued by the entity, variability in periodic interest receipts/payments is not considered a risk that the entity is designed to create and pass along to interest holders.

View B: Interest rate risk is a risk that the entity is designed to create and pass along to interest holders.

Consistent with paragraph 7 of FSP FIN 46(R)-6, proponents of View B believe that the determination of the purpose for which the entity is created and the variability the entity is designed to create and pass along requires an analysis of certain factors including (1) how the entity's interests were negotiated or marketed to potential investors and (2) the nature of the entity's interests issued.

In this case, proponents of View B believe that an MMF is marketed to potential investors as an investment that exposes investors to both interest rate and credit risk. Proponents of View B point to the fact that the prospectus of some MMFs provide that the investments held by an MMF expose the Fund to interest rate risk (in the form of reinvestment risk associated with the continual need to replace maturing short-term assets at then current market interest rates) and credit risk (in the form of the risk of the obligor on the Fund's assets failing to pay interest or principal on the obligations). They point to the marketing materials for one of the three largest MMFs in the U.S. Such marketing materials define an MMF as "A mutual fund that seeks to provide income, liquidity, and a stable share price by investing in very short-term, liquid investments." In describing the risk attributes of the Fund, the marketing materials on a particular Fund sponsor's website state:

Keep in mind that investments that offer stability of principal typically are the most vulnerable to **income risk**—the possibility that the income from the investment will fluctuate over brief periods—and tend to produce lower long-term returns than riskier assets. [Emphasis added.]¹⁶

View B proponents believe that excluding variability in cash flows associated with interest/reinvestment risk seems inconsistent with the stated purpose of an MMF as supported by its prospectus and marketing materials is inconsistent with the decision that most investors make when becoming involved with an MMF, which is to compare MMF yields with those offered by comparable bank products (that is, savings accounts and interest bearing checking accounts).

¹⁶ From the prospectus for Vanguard Prime Money Market Fund.

In identifying the risks that an MMF is designed to create and pass along to its interest holders, View B proponents believe it is helpful to consider the risks inherent in an MMF prior to a sponsor stepping in to provide the types of support described in the background section of this potential issue. In performing such an analysis, View B proponents believe that the single class nature of the interests issued by an MMF entitles/(exposes) Fund shareholders to the net income/(loss) of the MMF. Prior to the sponsor providing credit support, the net income of a MMF equals the excess of interest receipts over the sum of organizational/administrative expenses and credit losses (if any). Because MMFs do not typically have any explicit subordinated classes of interests or other explicit contractual arrangements that are designed to absorb variability, proponents of View B believe that all net income and, therefore, variability that an MMF's assets create is designed to be passed along to its single class of interest holders.

Supporters of View B agree with View A proponents that paragraph 12 has been interpreted by many to indicate that the mere "pass through" of interest receipts to an entity's interest holders should not cause one to conclude that the entity was designed to create and pass along interest rate risk. However, in an instance such as an MMF for which a single class of interest holder exists and (prior to any reconsideration event) is contractually required to absorb 100 percent of the variability in the entity's cash flows (which are themselves generated (by design) by a single class of multi-issuer, homogenous assets), View B proponents believe that excluding from a variability analysis one (interest rate) of only two (interest rate and credit) identified risks seems arbitrary.

View C: Recommend that the Board consider an additional scope exception to be included in paragraph 4 of Interpretation 46(R) that would state that an enterprise that holds a variable interest in a money market mutual fund regulated by the 1940 Act should not evaluate that interest under Interpretation 46(R).

Proponents of View C acknowledge that it is unclear from the existing literature whether interest rate risk is a risk a Fund was designed to create and pass along to its interest holders. They note that while the shareholders in an MMF may be provided with some protection by the Fund's

sponsor, the extent of such protection would be difficult to measure in practice given the non-contractual nature of the credit support provided by the sponsor coupled with the fact that the extent of any support provided will typically vary from sponsor to sponsor and would likely be influenced by:

- The absolute dollar amount of support needed to avoid "breaking the buck"
- The liquidity of the sponsor
- The risk/reward relationship between the cost of any support provided by the sponsor and future fees to be collected from a continued presence in the MMF sector
- The risk tolerance and economic outlook held by the sponsor's investment management team.

In addition, proponents of View C acknowledge that there are broader implications to the Task Force reaching a consensus on either View A or View B. If the Task Force reaches a consensus that View B is appropriate, companies may inappropriately conclude that interest rate risk should be considered in other structures, resulting in an increase in scenarios where no enterprise absorbs/receives the majority of expected losses or residual returns. Conversely, if the Task Force reaches a consensus that View A is appropriate, it is possible that sponsors would consolidate the MMFs under their management. For the same reasons described in the background section of this potential issue, View C proponents do not believe that the consolidation of an MMF by a sponsor would provide users of the sponsor's financial statements with meaningful information, and therefore are unwilling to support a view that would result in consolidation (as either View A or View B might in individual situations).

Opponents of View C believe that there is only one way to apply FSP FIN 46(R)-6, and concluding on either View A or View B would appropriately resolve the existing diversity in practice. They believe that it would be inappropriate to provide a scope exception that would in all cases prevent an MMF from being considered a variable interest entity.

Opponents of View C also believe it would be impractical to provide a scope exception for MMFs. They note that there are unregulated funds and other structures that are designed and

intended to operate to the same standards as MMFs, and that the principles of Interpretation 46(R) should be applied to each of those entities, regardless of their legal structure.

Additional Items to Consider

Many will argue that this issue is integral to the consistent application of Interpretation 46(R) and has the potential to influence the manner in which practitioners consider interest rate risk in a wide variety of structures beyond those contemplated above, including commercial paper conduits, SIVs, and CDO arrangements.

Agenda Committee Decision: *The Agenda Committee decided not to add this issue to the EITF agenda.*

4. Revenue Recognition for a Single Deliverable or a Single Unit of Accounting (with Multiple Deliverables) That Have Multiple Payment Streams

Background

Companies often enter into arrangements that provide for multiple payment streams for a single deliverable¹ or a single unit of accounting (that is, multiple deliverables that cannot be separated for revenue recognition purposes). 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 biotechnology and pharmaceutical research and development arrangements involving multiple deliverables, up-front payments, payments for specific services, and payments upon achieving certain clinical milestones. To recognize revenue in these arrangements, a company needs to determine how to attribute the multiple payment streams (customer consideration) to the single deliverable or unit of accounting (assuming multiple deliverables cannot be separated under EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables").

Practice for these types of arrangements is currently mixed. Some determine a single attribution method for all consideration received regardless of the structure/timing of the payments from the customer or the specific facts and circumstances of the arrangement (for example, all consideration is recognized on a straight-line basis over time or on a per unit basis; but not both). Others determine attribution methods for each payment stream based on the specific facts and circumstances of the arrangement (for example, an up-front payment may be recognized on a straight-line basis over time while a price paid per unit may be recognized as units are delivered).

The conceptual issue discussed herein is pervasive and broad in practice and could impact almost any arrangement with a fixed and variable fee component. In more complex arrangements, such as the biotechnology and pharmaceutical arrangements that involve the transfer of a license or intellectual property with significant milestone payments, the use of the alternative views presented in this issue could have a significant impact on the timing of revenue recognition.

¹ A deliverable may include the delivery of multiple items within a single class of deliverables. For example, an arrangement may require the delivery of a number of the same product or service (for example 250 widgets or 250 hours of service) – for purposes of this potential issue such items are considered a single deliverable.

Consequently the accounting for these arrangements can vary significantly depending on the attribution method used.

Issue 00-21 provides guidance to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting but as stated in paragraph 3, it does not address when the criteria for revenue recognition are met or provide guidance on the appropriate revenue recognition convention for a given unit of accounting. The timing of revenue recognition for a given unit of accounting will depend on the nature of the deliverable(s) composing that unit of accounting (and the corresponding revenue recognition convention) and whether the general conditions for revenue recognition have been met. Current guidance does not explicitly address whether or not the use of multiple attribution methods for a single deliverable or single unit of accounting would be acceptable.

Accounting Issues and Alternatives

Issue 1: Whether it is acceptable to use multiple methods to attribute multiple payment streams to a single deliverable.

View A: It is not acceptable to use multiple methods to attribute consideration in an arrangement with a single deliverable.

Since there is a single deliverable in the arrangement, a single attribution method should be used for all consideration received regardless of the structure or timing of the payments received from the customer or the specific facts and circumstances of the arrangement. Proponents of View A believe that all payments, regardless of how the payments are structured or timed, relate to the single deliverable and, therefore, need to be recognized in the same manner.

Proponents of View A point to Question 1 of SAB Topic 13-A.3(f), in which the SEC refers to a service arrangement in which an up-front fee is charged with subsequent periodic payment for future products or services. Question 1 of SAB Topic-A.3(f) states, in part:

Supply or service transactions may involve the charge of a nonrefundable initial fee with subsequent periodic payments for future products or services. The initial fees may, in substance, be wholly or partly an advance payment for future products or services. In the examples above, the on-going rights or services being provided or products being delivered are essential to the customers receiving the expected benefit of the up-front payment. Therefore, the up-front fee and the continuing performance obligation related to the services to be provided or products to be delivered are assessed as an **integrated package**. In such circumstances, the staff believes that up-front fees, even if nonrefundable, are earned as the products and/or services are delivered and/or performed over the term of the arrangement or the expected period of performance and generally should be deferred and recognized systematically over the periods that the fees are earned.¹ [Emphasis added.]

¹ A systematic method would be on a straight-line basis, unless evidence suggests that revenue is earned or obligations are fulfilled in a different pattern, in which case that pattern should be followed.

Proponents of View A further note that no current guidance in GAAP exists to support multiple attribution methods for a single deliverable. They also acknowledge that proponents of View B use similar GAAP references to support their view. The fact that the GAAP references can be interpreted in a manner that appears to support either view serves as an indication that the existing guidance for this issue is unclear.

View B: It may be acceptable to use multiple methods to attribute consideration in an arrangement with a single deliverable under certain facts and circumstances.

Depending on the facts and circumstances of an arrangement, the use of a separate method for attributing multiple payment streams or earnings processes to a single deliverable may be appropriate. For varying reasons, arrangements with a single deliverable may require unique, and sometimes complex, payment structures. In those circumstances, the use of a single method to attribute customer consideration to the deliverable could result in recognizing revenue in a manner that is inconsistent with the manner in which the earnings process is completed under the arrangement. Proponents of View B believe that current practice supports the use of multiple attribution methods under certain circumstances and also point to Question 1 of SAB Topic 13-A.3(f). In Question 1, the SEC staff refers to a service arrangement in which an up-front fee is charged with subsequent periodic payment for future products or services. Notwithstanding the

fact that proponents of View A use it as support for their view, the example provided in the guidance seems to indicate that recognition of a nonrefundable initial fee systematically over the period of the arrangement, while recognizing the payments for products or services separately, is acceptable. Specifically, Question 1 of SAB Topic 13-A. 3(f) states, in part:

Supply or service transactions may involve the charge of a nonrefundable initial fee with subsequent periodic payments for future products or services. The initial fees may, in substance, be wholly or partly an advance payment for future products or services. In the examples above, the on-going rights or services being provided or products being delivered are essential to the customers receiving the expected benefit of the up-front payment. Therefore, the up-front fee and the continuing performance obligation related to the services to be provided or products to be delivered are assessed as an integrated package. In such circumstances, the staff believes that up-front fees, even if nonrefundable, are earned as the products and/or services are delivered and/or performed over the term of the arrangement or the expected period of performance and generally should be deferred and recognized systematically over the periods that the fees are earned.¹

¹ A systematic method would be on a straight-line basis, unless evidence suggests that revenue is earned or obligations are fulfilled in a different pattern, in which case that pattern should be followed.

Another example in practice of the use of multiple attribution methods to a single deliverable is the use of a milestone-based method. The Miller Revenue Recognition Guide, by Ashwinpaul C. Sondhi and Scott Taub, describes the milestone-based method as follows:

The milestone-based method distinguishes between the up-front and milestone payments for accounting purposes instead of combining them, as is done in the performance-based methods. The up-front fee in the milestone-based method is deemed to relate to the entire performance period, since no discrete earnings process culminated upon receipt of the up-front fee. As such, the up-front fee is recognized over the performance period on a systematic and rational basis. If information related to efforts expended and total efforts expected to be expended is available, a basis centered on percentage-of-efforts expended should most likely be used. If such information is not available, the systematic and rational basis would most likely be a time-based method where the up-front fee is recognized ratably over the performance period. The milestone payments, however, are deemed to be related to the portion of the performance period dedicated to achieving that specific milestone. In substance, each milestone is treated as if it is a separate contract, performance for which is evaluated under a Completed Performance model.

Illustrative examples of the application of both views for a single deliverable are provided in Appendix 1.

Issue 2: Depending on the facts and circumstances of an arrangement, whether it is acceptable to use multiple methods to attribute multiple payment streams to a single unit of accounting (multiple deliverables that cannot be separated), as determined under Issue 00-21.

View A: It is not acceptable to use multiple methods to attribute consideration in an arrangement with a single unit of accounting (multiple deliverables that cannot be separated).

For similar reasons noted in Issue 1, proponents of View A believe payments related to a single unit of accounting as determined in accordance with Issue 00-21 should be recognized in the same manner. The separation criteria in Issue 00-21 were developed to determine whether an arrangement that contains multiple deliverables should be accounted for as a single unit or separate units. Paragraph 10 of Issue 00-21 discusses the appropriate revenue recognition when multiple deliverables **do not** qualify for separate accounting:

The arrangement consideration allocable to a delivered item(s) that does not qualify as a separate unit of accounting within the arrangement should be combined with the amount allocable to the other applicable undelivered item(s) within the arrangement. The appropriate recognition of revenue should then be determined for those combined deliverables as a single unit of accounting.

Proponents of View A believe that paragraph 10 should be interpreted to require that a determination of a single appropriate revenue recognition method for the combined deliverables be made and that the use of multiple methods of revenue recognition would not be appropriate. By allowing multiple methods of attribution for a single unit of accounting, companies could account for an arrangement with multiple deliverables as if the deliverables qualified for separation even when the separation criteria had failed under Issue 00-21—essentially creating "synthetic" separation. Consequently, allowing multiple attribution methods for a single unit of

accounting with multiple deliverables could result in circumventing the separation criteria in Issue 00-21.

View B: It may be acceptable to use multiple methods to attribute consideration in an arrangement with a single unit of accounting (multiple deliverables that cannot be separated) under certain facts and circumstances.

Similar to Issue 1, depending on the facts and circumstances of an arrangement, the use of a separate method for attributing each payment stream to a single unit of accounting may be appropriate. Assuming View B is deemed appropriate in Issue 1, the existence of multiple deliverables should not change the conceptual basis for using different methods to attribute payment streams or earnings processes to a single unit of accounting consisting of multiple deliverables that cannot be separated as a result of the requirements of Issue 00-21.

Contrary to View A, proponents of View B believe that paragraph 10 requires a determination of an appropriate revenue recognition method, which may be a single attribution method or multiple attribution methods for the deliverables in an arrangement. Proponents believe that in certain circumstances, especially those in which fair value is determinable for certain deliverables within a single unit of accounting, appropriately recognizing revenue for a single unit of accounting in accordance with paragraph 10 may necessitate the use of multiple attribution methods. By allowing multiple attribution methods for a single unit of accounting with multiple classes of deliverables when circumstances warrant such an approach, the principles of revenue recognition are maintained. Professional judgment would be required to determine when the use of a single method or different methods to attribute each payment stream to a single unit of accounting is appropriate. This may include, among other considerations, an evaluation of the sufficiency of revenue streams to appropriately account for future remaining deliverables under each arrangement.

Supporters of View B also point to the concept in AICPA TPA 5100.76, *Fair Value in Multiple-Element Arrangements That Include Contingent Usage-Based Fees and Software Revenue Recognition*, which is that revenue for a combined unit of accounting is recognized using

separate attribution methods. In the TPA, the non-refundable initial fee for a perpetual license is recognized ratably over the period, while the contingent usage-based fee is recognized at the time a reliable estimate can be made of the actual usage that has occurred, provided collectibility is probable.

Illustrative examples of the application of both views for a single unit of accounting are provided in Appendix 2.

Agenda Committee Decision: *The Agenda Committee agreed to add this issue to the EITF agenda.*

Appendix 1

ILLUSTRATIVE EXAMPLES – SINGLE DELIVERABLE

Example 1 – Professional Legal Services

Law Firm enters into an agreement with Telecom, a multi-national telecommunications company. The agreement engages Law Firm to be general external counsel to Telecom for a period of 12 months and specifically prohibits Law Firm from providing legal services to Telecom's competitors in the telecommunications industry. Upon commencement of the agreement Telecom will pay Law Firm a one time non-refundable retainer fee of \$500,000. All legal services provided to Telecom by Law Firm during the agreement term will then be charged at Law Firm's standard rate of \$300 per hour. Law Firm has determined that the providing of legal services is the only deliverable included in the agreement. Neither the Law Firm's obligation to stand ready during the 12-month term nor the exclusivity provision is considered to be a separate deliverable within the agreement. Law Firm has also determined that there is objective evidence of fair value for its deliverable (that is, legal services at \$300 per hour) as the hourly fee charged by Law Firm is consistent with rates that Law Firm charges to other clients as well as rates charged by other general counsel in the marketplace. Given the fact that Law Firm has not previously been contracted by Telecom and given the nature of the services to be provided, Law Firm is unable to estimate the timing and extent of legal services that will be provided to Telecom at the rate of \$300 per hour. However, Law Firm does not believe such services will be rendered evenly throughout the annual contractual period but, rather, sporadically as Telecom pursues potential acquisition/disposition transactions and as general litigation matters arise.

Example 2 – Clothing Manufacturer

Company N designs, markets, and sells premium outdoor apparel. Company M is a textile manufacturer specializing in the development, design, and production of high quality, high performance materials that are used in the manufacturing of outdoor clothing. Company M has recently developed a waterproof breathable fabric that allows for maximum flexibility and is extremely resistant to tearing. Company M has obtained a patent related to this "state of the art" material. Under the terms of a new five -year agreement entered into between Company N and Company M, Company M will manufacture outdoor jackets using Company M's waterproof breathable fabric for Company N. Company N will distribute the jackets under N's own trademark. During negotiations of the agreement, Company N agreed to pay an up-front payment to Company M in order to help subsidize the purchase of additional equipment and machinery that Company M will need in order to have sufficient manufacturing capacity to meet expected demand for the jackets. Company M has determined that the providing of manufacturing services and delivery of jackets is the only deliverable within the agreement. Company M's obligation to increase capacity levels and devote manufacturing capacity to Company N is not considered a separate deliverable within the arrangement.

Under the terms of the agreement, Company M will receive an up-front non-refundable fee of \$1,000,000. In addition, Company M will receive fees equal to "cost plus 30 percent" for the

manufacturing of the outdoor jackets. The manufacturing fee amount and structure is comparable to fees charged by Company M in other manufacturing arrangements as well as fees charged by other companies in the apparel manufacturing industry, therefore Company M has determined that the "cost plus 30 percent" fee represents objective evidence of fair value for this deliverable (that is, manufacturing jackets at cost plus 30 percent). Company M is unable to estimate the timing and extent of the manufacturing of the jackets although Company M suspects that the manufacturing demand may be seasonal in nature.

Example 3 – Research and Development Arrangement

Company X entered into a 3-year agreement with Company Y to provide research and development services ("R&D services"). Company X will perform R&D services on a best efforts basis for Company Y and provide Company Y with the findings from all R&D services conducted by Company X. In order to provide the R&D Services at the levels requested by Company X, Company Y will need to recruit and hire additional researchers. In consideration for the services provided as well as for Company X to increase its research staff, Company X will be paid an up-front non-refundable fee of \$500,000 plus additional fees equal to \$200 per hour for each hour of R&D services provided to Company Y. Under the terms of the agreement, Company Y must pre-approve the number of R&D service hours to be incurred and the nature of the R&D services to be performed.

Company X has determined that the providing of R&D services is the only deliverable within the agreement. The recruiting and hiring of additional employees by Company X is not considered a deliverable within the agreement. Company X has determined that the \$200 per hour fee represents objective evidence of fair value for R&D services based on the fact that Company X provides R&D services to other companies at the standard rate of \$200 per hour, which is also comparable to the rates charged by other companies providing R&D services. Company X is unable to estimate the extent and timing of the total R&D service hours it will incur pursuant to the contract with Company Y and does not believe such services will be rendered evenly throughout the term of the agreement due to the timing of regulatory and other third party reviews that may take place during the term of the agreement.

Table 1

Example	Payment Streams	Revenue Recognition View A	Revenue Recognition View B
(1) Professional Legal Services	Annual retainer fee of \$500,000 paid upon commencement of the agreement Fees for legal services provided at the rate of \$300 per hour	Retainer fee of \$500,000 and the fees for legal services at \$300 per hour shall be recognized ratably over the agreement term,* using the same attribution method.	Retainer fee of \$500,000 shall be recognized ratably over the agreement term.* Recognition of revenue related to legal services at \$300 per hour shall be recognized as services are provided.
(2) Clothing Manufacturer	Up-front fee of \$1,000,000 Manufacturing fees equal to "cost plus 30 percent" as manufacturing services are provided.	Up-front fee of \$1,000,000 and the manufacturing fees of "cost plus 30 percent" shall be recognized ratably over the agreement term,* using the same attribution method.	Up-front fee of \$1,000,000 shall be recognized ratably over the agreement term.* Revenue related to manufacturing services at "cost plus 30 percent" shall be recognized as the delivery of manufactured products occurs.
(3) Research and Development Arrangement	Up-front fee of \$500,000 Fees for R&D services provided at the rate of \$200 per hour	Up-front fee of \$500,000 and the fees for R&D services at \$200 per hour shall be recognized ratably over the agreement term,* using the same attribution method.	Up-front fee of \$500,000 shall be recognized ratably over the agreement term.* Recognition of revenue related to R&D services at \$200 per hour shall be recognized as services are provided.

* Based on facts and circumstances of specific transactions, different systematic and rational methods may be used to recognize revenue ratably over the agreement term. Those systematic and rational methods include but are not limited to; (a) the straight line method whereby revenues would be recognized on a straight line basis from the date they become due through the remaining agreement term; (b) the cumulative catch up model whereby upon amounts being due, any amounts representing fees "earned," using a proportional performance measure (for example, output, time-based, and so forth), would be recognized immediately and "unearned" fees would be deferred and amortized over the remaining agreement term, and (c) the expected revenue model whereby revenue earned at any point in time is recognized using a proportional performance method (for example, output, time-based, and so forth) based upon total expected revenue and "units" expected to be delivered under the terms of the agreement. In some cases, revenue may be earned or obligations fulfilled in a pattern not supported by ratable recognition and, therefore, another pattern of recognition should be considered. For the purposes of the above examples and table, such cases are not contemplated.

Note: Using the straight-line method or the cumulative catch-up model under View A results in recognizing increasing revenues during the latter portion of the agreement term, even in situations in which there is no corresponding increase of actual performance during the latter portion of the agreement term.

Appendix 2

ILLUSTRATIVE EXAMPLES – MULTIPLE DELIVERABLES

Example 1 – Professional Legal Services

Similar facts as those in Example 1 of Appendix 1 except that upon commencement of the agreement Telecom will pay Law Firm a one time non-refundable retainer fee of \$1,000,000. In addition to Law Firm being engaged as external general counsel, the agreement also entitles Telecom to receive weekly legal newsletters drafted by Law Firm that outline current legal events that may affect Telecom's business, as well as quarterly updates presented in-person by Law Firm's attorneys, which will provide Telecom management with an opportunity to pose questions to Law Firm lawyers regarding current events in relation to Telecom's current operations and events and anticipated future plans. At any time during the term of the agreement Telecom can request that these meetings occur on a monthly basis if Telecom believes that a monthly in-person meeting would be more beneficial. In addition to the weekly newsletters and meetings, Law Firm is also obligated to provide services in connection with the review and drafting of all scheduled and unscheduled board presentations as well as all public press releases issued by Telecom during the term of the agreement. All legal services provided to Telecom at Telecom's request during the term of the agreement that are outside of the scope of services described above (that is, newsletters, meetings, drafting and review services) will be charged at Law Firm's standard rate of \$300 per hour.

Law firm has determined that there are 4 separate deliverables included within the agreement; (1) weekly newsletters, (2) quarterly/monthly live legal updates, (3) drafting and review services in connection with board presentations and press releases, and (4) providing legal services at the rate of \$300 per hour. Law Firm does not have objective evidence of fair value for weekly newsletters, quarterly/monthly live legal updates, and drafting and review services in connection with board presentations and press releases, as Law Firm does not separately sell these deliverables. These services are only offered in connection with providing external general legal service to a client and in connection with receiving a retainer fee. Further, based upon the fact that Law Firm has not served Telecom in this capacity previously, it is unclear as to how many live meetings will be requested and how many presentations and press releases will be reviewed by Law Firm. The timing of these review services is also unpredictable.

For reasons similar to those in Example 1 of Appendix 1, Law Firm has determined that there is objective evidence of fair value for its legal services at \$300 per hour. Given the fact that Law Firm has not previously been contracted by Telecom and given the nature of the services to be provided, Law Firm is unable to estimate the timing and extent of legal services which will be provided to Telecom at the rate of \$300 per hour. However, Law Firm does not believe such services will be rendered evenly throughout the annual contractual period but, rather, sporadically as Telecom pursues potential acquisitions/disposition transactions and as general litigation matters arise.

Pursuant to guidance included in Issue 00-21, Law Firm has determined that its deliverables pursuant to the agreement with Telecom do not meet the criteria for separate units of accounting

because objective evidence of fair value for certain undelivered items (weekly newsletters, quarterly/monthly live legal updates, and drafting and review services in connection with board presentations and press releases) included in the agreement does not exist. Accordingly, Law Firm must account for all deliverables included in the agreement as a single unit of accounting under paragraph 10 of Issue 00-21 and determine the appropriate recognition of revenue for the combined deliverables as a single unit of accounting.

Example 2 – Clothing Manufacturer

Similar facts to Example 2 of Appendix 1 except that under the terms of the 5-year agreement, Company M is required to conduct various design and market feasibility studies related to the development of footwear and pants made with Company M's patented waterproof breathable fabric, which, if developed, will be distributed by Company N under its trademark. Further, the agreement allows Company N to require Company M to also manufacture the footwear and pants that arise from the various design and market feasibility studies being performed, to be distributed by Company N under its trademark, when available. During negotiations of the agreement, Company N agreed to pay an up-front payment to Company M in order to help subsidize the purchase of additional equipment and machinery that Company M will need in order to have sufficient manufacturing capacity to meet expected demand for the various products. Company M has determined that there are two deliverables included in the arrangement; (1) manufacturing services and (2) design and market feasibility studies. Under the terms of the agreement, Company M will receive an up-front non-refundable fee of \$3,000,000. In addition, Company M will receive fees equal to "cost plus 30 percent" for the manufacturing of the jackets, and any future manufacturing of footwear and pants. Company M is unable to estimate the timing and extent of the manufacturing although Company M suspects that the manufacturing demand may be seasonal in nature.

For reasons similar to those in Example 2 of Appendix 1, Company M has determined that the "cost plus 30 percent" fee represents objective evidence of fair value for manufacturing services. Objective evidence of fair value for the design and market feasibility studies cannot be determined as the services are extremely customer specific and vary greatly in the types and quantity of studies that may be performed during the agreement and that may be expected at the outset of an agreement.

Pursuant to guidance included in Issue 00-21, Company M has determined that its deliverables pursuant to the agreement with Company N do not meet the criteria for separate units of accounting because objective evidence of fair value for certain undelivered items (for example, design and market feasibility studies) included in the agreement does not exist. Accordingly, Company M must account for all deliverables included in the agreement as a single unit of accounting under paragraph 10 of Issue 00-21 and determine the appropriate recognition of revenue for the combined deliverables as a single unit of accounting.

Example 3 – Research & Development Arrangement

Similar facts to those in Example 3 of Appendix 1 except Company X will provide Company Y with the findings from all R&D services conducted by Company X. In order to provide the R&D Services at the levels requested by Company Y, Company X will need to recruit and hire additional researchers. Company X is also required to have its CEO and Chief Science Officer participate in a steering committee with Company Y to discuss R&D findings and provide direction for the ongoing R&D services.² Company X has determined that its involvement in the steering committee would be considered a deliverable under Issue 00-21, and, therefore, Company X has determined that there are two deliverables included in the agreement; (1) R&D services and (2) steering committee participation.³

In consideration for the services provided as well as for Company X to increase its research staff, Company X will be paid an up-front non-refundable fee of \$1,000,000 plus \$200 per hour for each hour of R&D service. Under the terms of the agreement, Company Y must pre-approve the number of R&D service hours to be incurred and the nature of the R&D services to be performed.

For reasons similar to those in Example 3 of Appendix 1, Company X has determined that the \$200 per hour fee represents objective evidence of fair value for R&D services. Company X is unable to estimate the extent and timing of the total R&D service hours it will incur pursuant to the contract with Company Y and does not believe such services will be rendered evenly throughout the term of the agreement due to the timing of regulatory and other third party reviews that may take place during the term of the agreement. Company X is unable to determine the fair value of the steering committee participation.

Pursuant to guidance included in Issue 00-21, Company X has determined that its deliverables pursuant to the agreement with Company Y do not meet the criteria for separate units of accounting because objective evidence of fair value for the undelivered item consisting of the participation in the steering committee does not exist. Accordingly, Company X must account for all deliverables included in the agreement as a single unit of accounting under paragraph 10 of Issue 00-21 and determine the appropriate recognition of revenue for the combined deliverables as a single unit of accounting.

² For purposes of this example it is assumed that Company X evaluated its obligations under the agreement and determined its required participation on the steering committee represented a deliverable. However, in many research and development arrangements participation on a steering committee would not be a deliverable.

³ A simplified example has been used in this Appendix. In practice, research & development arrangements are often complex and contain multiple deliverables such as license rights, R&D services, joint steering committee obligations, and product manufacturing combined with multiple payment streams including up-front payments, on-going monthly payments, contingent milestone payments, and royalty payments upon the sale of developed products.

Table 2

Example	Payment Streams	Revenue Recognition View A	Revenue Recognition View B
(1) Professional Legal Services (Accounted for as a single unit of accounting pursuant to Issue 00-21, which includes the following multiple deliverables; (a) weekly newsletters, (b) quarterly/monthly live legal updates, (c) drafting and review services in connection with board presentations and press releases, and (d) providing legal services at the rate of \$300 per hour.)	Annual retainer fee of \$1,000,000 paid upon commencement of the agreement Fees for legal services provided at the rate of \$300 per hour	Retainer fee of \$1,000,000 and the fees for legal services at \$300 per hour shall be recognized ratably over the agreement term,* using the same attribution method.	Retainer fee of \$1,000,000 shall be recognized ratably over the agreement term.* Revenue related to legal services at \$300 per hour shall be recognized as services are provided.
(2) Clothing Manufacturer (Accounted for as a single unit of accounting pursuant to Issue 00-21, which includes the following multiple deliverables; (a) manufacturing services and (b) design and market feasibility studies.)	Up-front fee of \$3,000,000 Manufacturing fees equal to "cost plus 30 percent" as manufacturing services are provided.	Up-front fee of \$3,000,000 and the manufacturing fees of "cost plus 30 percent" shall be recognized ratably over the agreement term,* using the same attribution method.	Up-front fee of \$3,000,000 shall be recognized ratably over the agreement term.* Revenue related to manufacturing services at "cost plus 30 percent" shall be recognized as the delivery of manufactured products occurs.
(3) Research and Development Arrangement (Accounted for as a single unit of accounting pursuant to Issue 00-21, which includes the following multiple deliverables; (a) R&D services and (b) steering committee participation.)	Up-front fee of \$1,000,000 Fees for R&D services provided at the rate of \$200 per hour	Up-front fee of \$1,000,000 and the fees for R&D services at \$200 per hour shall be recognized ratably over the agreement term,* using the same attribution method.	Up-front fee of \$1,000,000 shall be recognized ratably over the agreement term.* Revenue related to R&D services at \$200 per hour shall be recognized as services are provided.

* Refer to the reference below Table 1 of Appendix 1.

5. Revenue Recognition by Lessors on Maintenance Payments in Lease Agreements

Background

Some contracts to provide goods or perform services may convey to the purchaser the right to use the underlying property, plant, and equipment. If those contracts meet certain criteria described in EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease," they include a lease that should be accounted for in accordance with FASB Statement No. 13, *Accounting for Leases*. These contracts also generally require the supplier (lessor) to maintain the underlying property, plant, and equipment, and these maintenance services may be substantial to the contract. In some of these arrangements, the supplier (lessor) is reimbursed for maintenance services, but these reimbursements may not coincide with the performance of the maintenance services.

At issue is how the supplier (lessor) should account for payments it receives in connection with maintenance services. This issue may exist in a number of industries, including airline, utility, shipping, trucking, and real estate industries. The following discussion is based on the example of a capacity purchase agreement in the airline industry as the issue was first identified in that industry. If this issue is added to the EITF agenda, the staff will need to further explore other industries that may be impacted by any potential Task Force conclusions.

Major airlines typically contract with regional airlines to provide connecting service into the major airline's hub. These contracts are often structured as capacity purchase arrangements under which the major carrier purchases the use of the regional airline's aircraft and flight crews and other related services. The aircraft is painted in the colors and logos of the major airline, and the major airline takes responsibility for aircraft scheduling, ticket pricing, reservations, collections, and marketing. The major airline generally pays the regional airline a rate based on certain flying statistics.

Capacity purchase agreements have different structures for how the major airlines are billed for the costs to operate the regional airline service. Under some capacity purchase agreements, the major airline is required to make payments to the regional airline for planned major maintenance

on a flight-hour basis, which does not always coincide with the performance of the maintenance services and incurrence of the maintenance costs by the regional. Under other capacity purchase agreements, the major airline is required to make payments to the regional airline for planned major maintenance on a cost-plus basis when the maintenance costs are incurred by the regional airline. The basic structures are described as follows:

- *Fee-Per-Departure Contracts*—Under fee-per-departure contracts, the regional carrier is compensated based on a rate per departure. The rate is intended to cover all of the costs and a profit margin for operation of the specified flight. The rate is generally either a per departure amount (for a specified origin and destination) or an amount per block hour of operation.
- *Cost-Based Contracts*—Under cost-based contracts, the regional carrier is compensated generally based on specific costs it incurs plus a margin. Typically, the regional carrier's revenue consists of three elements: reimbursement of costs over which the regional carrier has control, referred to as controllable costs; reimbursement of costs over which the regional carrier typically has no control, referred to as actual or pass-through costs; and a profit or margin component.

Costs of planned major maintenance activities are generally incurred on a very irregular basis (for example, major engine and airframe overhaul activities generally occur every third or fourth year depending on aircraft utilization). The pattern of maintenance costs is affected by the age of the fleet operated by the regional airline. In circumstances in which the regional operates a relatively mature fleet of a sufficient size, maintenance costs will generally be relatively stable. In contrast, the operation of a new fleet would likely result in costs being very irregular because during the first few years of operations, the fleet would have very little maintenance cost.

Some regional airlines have entered into power-by-the-hour (PBTH) contracts to outsource maintenance and those contracts often transfer risks to a third-party maintenance service provider. From the lessor's perspective, the costs tend to be incurred in proportion to how the aircraft are operated (generally a fee per flight hour is paid by the airline to the PBTH vendor and expensed as incurred), which tends to result in an expense recognition pattern on a relatively straight-line basis over the PBTH contract.

Assuming that after an analysis under Issue 01-8 the capacity purchase agreement contains a lease, the next step is to consider separation of lease and related executory costs from non-lease elements included within the capacity purchase agreement in accordance with paragraph 4(a) of EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables".¹ The regional airline would first separate the portion of the capacity purchase agreement that pertains to the procurement of aircraft and related executory costs ("lease costs") from the portion of the agreement that pertains to payments for other services. The allocation of the arrangement consideration between lease and nonlease costs should be made on a relative fair value basis using the entity's best estimate of the fair value of the deliverables. Nonlease elements are evaluated under Issue 00-21 to determine whether there are separate units of accounting and how each unit should be accounted for under relevant accounting literature.

Statement 13 provides that executory costs such as insurance, maintenance, and taxes, together with any profit thereon, shall be excluded from minimum lease payments. Therefore, executory costs would be deducted from the costs related to the procurement of the aircraft. However, Statement 13 provides no specific guidance as to the accounting for executory costs, other than excluding them from the determination of minimum lease payments.

Accounting Issue and Alternatives

How the lessor (regional airline) should account for revenue related to planned major maintenance when it has concluded that a capacity purchase agreement contains a lease under Issue 01-8:

View A: Revenue related to planned major maintenance should be accounted for following FASB Technical Bulletin No. 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts.

Proponents of View A believe that the regional airline should analogize to Technical Bulletin 90-1 to determine how to recognize revenue related to planned major maintenance under a capacity purchase agreement. Based on guidance in paragraph 3 of Technical Bulletin 90-1, revenue

¹ This separation is supported by footnote 3 of Issue 00-21.

would be deferred and recognized in income on a straight-line basis over the contract period except in those circumstances in which sufficient historical evidence indicates that the costs of performing services under the contract are incurred on other than a straight-line basis. In those circumstances, revenue would be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract.

Opponents of View A believe that most capacity purchase agreements are not explicitly within the scope of Technical Bulletin 90-1. Technical Bulletin 90-1 applies to "separately priced extended warranty and product maintenance contracts." Technical Bulletin 90-1 provides that "a contract is separately priced if the customer has the option to purchase the services provided under the contract for an expressly stated amount separate from the price of the product." Therefore, opponents of View A believe that the definition of "separately priced" in Technical Bulletin 90-1 implies that, not only does the contract include a price for such services on a separate basis, but that the service could be independently obtained at the same price from the regional airline or another provider (referred to as "independently priced"). Opponents of View A believe that the guidance in Technical Bulletin 90-1 would not be applicable to *fee-per-departure contracts* because they do not contain separate pricing for the individual components, including maintenance, and, therefore, maintenance would not be considered "separately priced." Furthermore, opponents of View A believe that even *cost-based contracts* that specify the individual amount for the planned major maintenance activities would generally not meet the Technical Bulletin 90-1 requirement to have maintenance "independently priced" from the other contract components. They point out that it would be rare for the individual contract components to be separately negotiated to achieve an adequate return for that individual component (that is, a return that would be required for the specific risks and rewards associated with that individual component if it were sold on a stand-alone basis). Therefore, opponents of View A believe that it would be inappropriate to follow guidance in Technical Bulletin 90-1 to recognize revenue related to major maintenance activities.

View B: Payments related to planned major maintenance should be recognized on a straight-line basis over the lease term.

Proponents of View B believe that revenue related to maintenance should be recognized on a straight-line basis over the lease term. Proponents of View B analogize to leases of residential and office buildings that have a maintenance element built into rent. In the case of a building lease, a lessee is leasing "maintained" space and a portion of the lease payments is intended to cover lessor's maintenance costs. These proponents assert that in practice some lessors and lessees have not separated lease payments into the portion related to maintenance but, rather, have recognized it as revenue/expense on a straight-line basis (in the case of an operating lease). Proponents of View B argue that the major airline is leasing a "maintained" aircraft from the regional airline and, similar to a lessor of building space, the regional airline should be able to recognize revenue for the portion of rent payments attributable to maintenance on a straight-line basis.

Opponents of View B believe that the practice followed by some building lessors and lessees of not separating the portion of lease payments attributable to maintenance from the rest of the lease payment should not be analogized to due to the significance of the major maintenance activities. Those opponents argue that Issues 01-8 and 00-21 require separation of the lease from the maintenance portion of the executory contract and, accordingly, should be account for separately. Those opponents state that if the pattern of incurring the costs associated with performing services under the contract is other than on a straight-line basis, then revenue should be recognized accordingly. Opponents of View B believe that the most appropriate analogy is to Technical Bulletin 90-1 and that regional airlines should follow that guidance when determining how to account for payments related to planned major maintenance activities included in a capacity purchase agreement.

Agenda Committee Decision: *The Agenda Committee agreed to add this issue to the EITF agenda.*

6. Accounting by Lessees for Maintenance Deposits under Lease Agreements

Background

Under the terms of equipment lease agreements, a lessee is generally legally and contractually responsible for repair and maintenance of a leased asset throughout the lease term. Additionally, certain lease agreements include provisions requiring the lessee to make deposits¹ to the lessors in order to financially protect the lessor in the event the lessee does not properly maintain the leased asset. Under a typical arrangement, these deposits may be calculated based on a performance measure, such as hours of use of the leased asset, and are contractually required under the term of the lease to be used to reimburse the lessee for maintenance upon the completion of the required maintenance of the leased asset. If there are sufficient funds on deposit to reimburse the lessee for the maintenance costs initially paid by the lessee, the lessor is contractually required to reimburse the lessee for the maintenance. Reimbursements are generally limited to the lesser of the available deposits associated with the specific maintenance activity for which the lessee is requesting reimbursement, or the amount of accumulated maintenance deposits.

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

Finally, there may be situations 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 of the lease agreements provide that the lessor is entitled to retain such excess amounts; whereas other agreements specifically provide that, at the expiration of the lease agreement, such excess amounts are returned to the lessee. As

¹ Lease agreements often refer to these deposits as "maintenance reserves" or "supplemental rent." However, as further discussed below, they are generally deposits in economic substance because 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.

discussed in the views below, this potential issue is applicable only when excess amounts are retained to the lessor.

Accounting Issue and Alternatives

Whether lessees should account for the payments described above as a deposit or as contingent rental expense.

View A: Maintenance deposits should be accounted for as a deposit.

Proponents of View A believe that because (1) the maintenance deposits are contractually related to maintenance of the leased asset, and (2) paragraph 5(j) of FASB Statement No. 13, *Accounting for Leases*, specifically excludes executory costs such as maintenance from the determination of minimum lease payments, these payments should not be included in periodic rent expense but, rather, as part of executory costs that should be accounted for in accordance with the lessee's maintenance accounting policy.²

In applying the lessee's maintenance accounting policy to payments made to outside parties, proponents of View A further believe that because (1) the lessor is contractually required to use the deposits to reimburse the lessee upon the lessee's performance of contractually required activities (activities that the lessee fully expects to perform and in fact may be legally required to perform in order to be able to continue to utilize the leased asset in certain situations, such as with a leased aircraft) and (2) the payments do not transfer either the obligation to maintain the leased asset or the cost or quality risk associated with the maintenance activities to the lessor, such payments should be recorded as a deposit on the balance sheet to the extent recoverable through future maintenance activities. When the underlying maintenance is performed, it would

² Proponents of View A also note that in EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease," the Task Force concluded that "substantial services provided by the lessor (for example, significant operating services) are not executory costs within the scope of Statement 13" and that in such circumstances, the "Other elements of the arrangement not within the scope of Statement 13 shall be accounted for in accordance with other applicable generally accepted accounting principles." However, proponents of View A do not believe application of this consensus would impact their conclusion, as it would also require the payments to be accounted for in accordance with other applicable generally accepted accounting principles, and not as rent payments under Statement 13.

be accounted for as maintenance expense or capitalized in accordance with the lessee's maintenance accounting policy.

In situations in which the lessor is entitled to retain excess amounts at the end of the lease, but the lessee believes it is probable that the maintenance deposits will be utilized for maintenance activities and therefore will not be available to be retained by the lessor at the end of the lease, proponents of View A believe that the maintenance deposits represent a valid asset and should be recorded as a deposit. However, once it is determined that such amounts are not probable of being used to fund future maintenance expense, they should be recognized as additional rent expense at the time such determination is made. Therefore, proponents of View A do not believe the provisions in the lease regarding the ultimate disposition of any potential excess amounts at the end of the lease term impact a lessee's accounting for the deposits, provided it is probable that the maintenance deposits will be utilized for maintenance activities.

Opponents of View A believe that if the lessor is entitled to retain excess amounts at the end of the lease, maintenance payments required under a lease agreement should be accounted for as rentals under Statement 13 and other related lease accounting literature.

View B: Maintenance deposits should be accounted for as contingent rental expense.

Proponents of View B believe that unless the lease agreement specifically provides that any excess amounts will be returned to the lessee at the end of the lease, maintenance deposits required under a lease agreement should be accounted for as contingent rentals and recognized as an operating expense as they become payable, regardless of the underlying purpose of the payments or whether the obligation to maintain the leased asset or the cost or quality risk associated with the maintenance activities are transferred to the lessor. Proponents of View B believe, however, that if excess amounts are refundable to the lessee at the end of the lease, maintenance deposits should be accounted for as deposits.

Proponents of View B point to paragraph 5(n) of Statement 13 (as amended by FASB Statement No. 29, *Determining Contingent Rentals*), which states that payments required under a lease that

depend on a factor directly related to the future use of leased property, such as hours of use, are contingent rentals. Nonrefundable maintenance reserves, which are often termed additional basic rent or supplemental rent in lease agreements, vary based on usage of the leased asset. Therefore, proponents of View B believe that nonrefundable maintenance deposits are, or are similar to, contingent rentals. Paragraph 15 of Statement 13 provides that rentals under operating leases should be charged to expense over the lease term, as they become payable. Accordingly, proponents of View B believe that nonrefundable maintenance deposits should be recognized as expense over the lease term as they become payable.

Opponents of View B do not believe that a contingent rent model is appropriate for the following reasons:

- Payments made to a lessor that are contractually required to be returned to a lessee upon the lessee's performance of contractually required activities are not rentals, contingent or otherwise, and the resulting "round-tripping" of cash lacks substance and therefore should not drive the recognition of maintenance expense in a lessee's statement of operations.
- The lessee contractually has the full responsibility for the maintenance and bears all the risks associated with the cost and quality of such maintenance. The lessee, not the lessor, selects the maintenance service provider, or can choose to perform the maintenance internally.
- Using a contingent rent model would not correctly reflect the underlying risks and rewards associated with the lease contract and would inappropriately accelerate and smooth operating expenses in the early periods of the lease prior to when the maintenance activities actually occur.
- A contingent rent model would result in the lessee failing to recognize a valid asset (the deposits available to fund future expense) on its balance sheet.

Opponents of View B point out that Statement 13 provides specific guidance for the accounting for contingent rentals within the standard, but does not provide any guidance for the accounting for executory costs. As a result of the clear distinction between executory costs and contingent rentals within Statement 13, they do not believe there is any basis on which to conclude that an executory cost should be accounted for as though it was a contingent rental, particularly when the payments are contractually required to be returned to a lessee upon the lessee's performance of contractually required activities that the lessee fully expects to perform. Additionally, as noted above, if one does not consider these payments to be executory costs, then opponents of View B believe that the guidance in Issue 01-8 makes it clear that they should be "accounted for in accordance with other applicable generally accepted accounting principles," not Statement 13. Furthermore, if maintenance deposits were expensed when paid, the recognition of expense prior to the performance of the maintenance activities would be inconsistent with the direction taken by the FASB in FASB Staff Position AUG AIR-1, *Accounting for Planned Major Maintenance Activities*, to prohibit use of the accrue-in-advance method to account for planned major maintenance activities.

Agenda Committee Decision: *The Agenda Committee agreed to add this issue to the EITF agenda.*

FASB EMERGING ISSUES TASK FORCE
Proposed March 12, 2008 Meeting Agenda

<u>Issue Number</u>	<u>Issue</u>	<u>Proposed Time</u>	<u>Staff Assigned</u>
	Administrative Matters	11:00-11:30	Paul
	- New Issues		
	- Other Matters		
00-27	Application of EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," to Certain Convertible Instruments	11:30-12:00	Zecher
	* * * LUNCH * * *	12:00-12:45	
07-5	Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock	12:45-2:15	Stevens/ Malcolm
07-4	Application of the Two-Class Method under FASB Statement No. 128, <i>Earnings per Share</i> , to Master Limited Partnerships	2:15-3:00	Wyatt/ Zecher
	* * * BREAK * * *	3:00-3:15	
08-A	Revenue Recognition for a Single Deliverable or a Single Unit of Accounting (with Multiple Deliverables) That Have Multiple Payment Streams	3:15-4:45	Maples/ Wilks/ Elsbree
08-B	Revenue Recognition by Lessors on Maintenance Payments in Lease Agreements	4:45-5:15	Leverenz/ Nickell
08-C	Accounting by Lessees for Maintenance Deposits under Lease Agreements	5:15-5:45	Nickell/ Leverenz

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
00-27	Application of EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," to Certain Convertible Instruments	5/00	11/00, 1/01	3/08	TBD	Zecher	The Task Force will consider addressing the dormant issues and whether to codify Issues 98-5 and 00-27.	March 12, 2008 EITF meeting
07-4	The Application of the Two-Class Method under FASB Statement No. 128, <i>Earnings per Share</i> , to Master Limited Partnerships	4/07	6/07, 9/11, 11/07	3/8	Bielstein	Wyatt/ Zecher	The FASB staff will prepare an Issue Supplement for a future meeting	March 12, 2008 EITF meeting

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	Bielstein	Stevens/ Malcolm	The FASB staff will prepare an Issue Supplement for a future meeting	March 12, 2008 EITF meeting
08-A	Revenue Recognition for a Single Deliverable or a Single Unit of Accounting (with Multiple Deliverables) That Have Multiple Payment Streams	1/08	N/A	3/08	TBD	Maples/ Wilks/ Elsbree	The FASB staff will prepare an Issue Summary for a future meeting	March 12, 2008 EITF meeting
08-B	Revenue Recognition by Lessors on Maintenance Payments in Lease Agreements	1/08	N/A	3/08	TBD	Leverenz/ Nickell	The FASB staff will prepare an Issue Summary for a future meeting	March 12, 2008 EITF meeting
08-C	Accounting by Lessees for Maintenance Deposits under Lease Agreements	1/08	N/A	3/08	TBD	Nickell/ Leverenz	The FASB staff will prepare an Issue Summary for a future meeting	March 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, <i>Accounting for Derivative Instruments and Hedging Activities</i>	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	Lusniak	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, <i>Brokers and Dealers in Securities</i>	8/06	11/06	Not scheduled	Fanzini	Pending the outcome of the Board's project to amend ARB No. 43, <i>Restatement and Revision of Accounting Research Bulletins</i> .	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