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MINUTES OF THE JUNE 30–JULY 1, 2004 OPEN MEETING OF THE FASB EMERGING ISSUES TASK FORCE

Location: FASB Offices
401 Merritt 7
Norwalk, Connecticut

Wednesday, June 30, 2004

Starting Time:	1:00 p.m.
Concluding Time:	5:15 p.m.

Thursday, July 1, 2004

Starting Time:	8:00 a.m.
Concluding Time:	3:30 p.m.

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

Task Force Member Absent:
Richard H. Stock

* For certain issues only.

Others at Meeting Table:
Robert H. Herz, FASB Board Member
George J. Batavick, FASB Board Member
G. Michael Crooch, FASB Board Member
Gary S. Schieneman, FASB Board Member
Katherine Schipper, FASB Board Member
Leslie F. Seidman, FASB Board Member
Edward W. Trott, FASB Board Member
Russell G. Golden, FASB Senior Technical Advisor
Landon B. Westerlund, FASB Practice Fellow
Shelly C. Luisi, SEC Senior Associate Chief Accountant
Jane D. Poulin, SEC Associate Chief Accountant
* Richard Graff, Mining Industry Working Group Representative[1]
* Christopher J. Larson, FASB Practice Fellow
* Paul G. Laurenzano, FASB Practice Fellow
* Kevin T. McBride, FASB Industry Fellow
* Lisa M. Munro, FASB Practice Fellow
* Gerard M. O'Callaghan, FASB Practice Fellow
* Matthew H. Pinson, FASB Industry Fellow
* Randall S. Sogoloff, FASB Practice Fellow

* For certain issues only.

[1] Invited to discuss with the Task Force issues relating to EITF Issue No. 04-6, "Accounting for Stripping Costs Incurred during Production in the Mining Industry."

ADMINISTRATIVE MATTERS

- Prior Meeting Minutes. An FASB staff member solicited objections to the final minutes of the March 17–18, 2004 meeting. No objections were noted.

- The Task Force discussed the report on the EITF Agenda Committee meeting held on May 26, 2004. The following decisions and recommendations were made by the Agenda Committee:

a. *Determining Whether an Interest Is a Variable Interest in a Variable Interest Entity.* The Agenda Committee decided to add this Issue to the EITF's agenda and agreed that this Issue should be considered by the Task Force at the June 30–July 1, 2004 EITF meeting. Refer to the discussion of EITF Issue No. 04-7, "Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity," elsewhere in these minutes.

b. *Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights.* The Agenda Committee decided to add the broad issue of which rights held by a limited partner(s) preclude a sole general partner from consolidating a limited partnership. Additionally, the Agenda Committee agreed that this Issue should be considered by the Task Force at the June 30–July 1, 2004 EITF meeting. Refer to the discussion of EITF Issue No. 04-5, "Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights," elsewhere in these minutes.

c. *Accounting for Distribution Fees by Distributors of Mutual Funds That Do Not Have Front End Sales Charges and the Distributors Transfer the Rights to Such Fees.* The Agenda Committee decided <u>not</u> to add this issue to the EITF's agenda primarily because of the Board's pending project on revenue recognition. The Task Force Chairman indicated that the FASB staff will explore whether it should issue an FASB Staff Position (FSP) to address the accounting for certain distribution fees.

d. *Accounting Issues Related to Certain Features of Contingently Convertible Debt.* The Agenda Committee decided to add this Issue to the EITF's agenda and noted that the Task Force first should address whether the shares associated with these instruments are contingently issuable under paragraph 30 of FASB Statement No. 128, *Earnings per Share*. The Committee also agreed that this Issue should be considered by the Task Force at the June 30–July 1, 2004 EITF meeting. This Issue has been combined with Item (e), below. Refer to the discussion of EITF Issue No. 04-8, "The Effect of Contingently Convertible Debt on Diluted Earnings per Share," elsewhere in these minutes.

e. *The Effect of Contingently Convertible Debt on Diluted Earnings per Share.* The Agenda Committee decided to add this Issue to the EITF's agenda. The Committee also agreed that this Issue should be considered by the Task Force at the June 30–July 1, 2004 EITF meeting. This Issue has been combined with Item (d), above. Refer to the discussion of Issue 04-8 elsewhere in these minutes.

f. *The Meaning of Similar Economic Characteristics.* The Agenda Committee decided to add this Issue to the EITF's agenda. This Issue will address whether it is possible for two operating segments to have different expected long-term results and still have similar economic characteristics for the purposes of aggregating the segments under FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*. This Issue will be combined with Item (g), below.

g. *Aggregation of Operating Segments That Do Not Meet the Quantitative Thresholds.* The Agenda Committee decided to add this Issue to the EITF's agenda. This Issue will address how an entity should consider the aggregation criteria listed in paragraph 17 of Statement 131 when aggregating operating segments that do not meet the quantitative thresholds for a reportable segment. This Issue will be combined with Item (f), above.

h. *Proposed Removal of EITF Issue No. 03-S, "Application of FASB Statement No. 142,* Goodwill and Other Intangible Assets*, to Oil and Gas Companies," from the EITF Agenda Based on a proposed FASB Staff Position*. The FASB staff proposed that an FSP be issued to clarify that the exception in paragraph 8(b) of Statement 142 includes the balance sheet classification and disclosures for drilling and mineral rights of oil- and gas-producing entities. Accordingly, the staff recommended that this Issue be removed from the EITF agenda because the proposed FSP will address the practice issue. The Agenda Committee recommended and the Task Force agreed to remove this Issue from the EITF's agenda. The FASB staff will post the proposed FSP to the FASB website for public comment in the near future.

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

a. EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128, *Earnings per Share*" (2 comment letters)
b. EITF Issue No. 04-7, "Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity" (2 comment letters)
c. EITF Issue No. 04-8, "The Effect of Contingently Convertible Debt on Diluted Earnings per Share" (2 comment letters).

- 2004 EITF Meeting dates. The Task Force Chairman formally confirmed the November 18, 2004 EITF meeting date.

- The Task Force held a closed administrative session to discuss the use of working groups and an FASB staff initiative on the codification of accounting standards.

- An FASB staff member reminded constituents that EITF discussion materials (Issue Summaries, Issue Summary Supplements, Working Group Reports, and comment letters) are now being made available to constituents free of charge via posting to the FASB website (www.fasb.org). Minutes will also be made available following each meeting. Postings coincide with distributions to Task Force members.

DISCUSSION OF AGENDA TECHNICAL ISSUES

Issue No. 02-14

Title: Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock

Dates Discussed: September 11–12, 2002; November 21, 2002; January 23, 2003; March 20, 2003; November 12–13, 2003; March 17–18, 2004; June 30–July 1, 2004

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

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

FASB Statement No. 128, *Earnings per Share*

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

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

FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock*

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

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

APB Opinion No. 20, *Accounting Changes*

AICPA Accounting Interpretation 2, "Investments in Partnerships and Ventures," of APB Opinion No. 18

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

Introduction

1. In March 1971, the Accounting Principles Board issued Opinion 18 to prescribe accounting standards for common stock investments under the equity method. Paragraph 17 of Opinion 18 states, "… the equity method of accounting for an investment in common stock should also be followed by an investor whose investment in *voting stock* gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock" (emphasis added). Paragraph 2 of Opinion 18 states that "the Opinion also does not apply to investments in common stock other than those described in the Opinion." By inference, the scope of Opinion 18 is restricted to voting common stock. The scope of Opinion 18 was soon questioned, and, in November 1971, the AICPA issued

Interpretation 2 of Opinion 18, which reemphasized that "APB Opinion No. 18 applies only to investments in common stock of corporations…."[1]

2. Since 1971, the type and form of investment vehicles have proliferated beyond those in voting common stock; such investment vehicles include convertible debt, preferred equity securities, options, warrants, interests in unincorporated entities, complex licensing and management arrangements, as well as a host of other idiosyncratic financial instruments. These investment vehicles are designed to maximize an investor's return on investment and reduce the cost of capital for an investee; furthermore, they can convey—by contract, articles of incorporation, indenture, or other means—any combination of rights, privileges, or preferences including (a) the right to vote with common stockholders, (b) the right to appoint members of the board of directors, (c) substantive participating rights as described in EITF Issue No. 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights," (d) protective rights as described in Issue 96-16, (e) cumulative and participating dividends, and (f) liquidation preferences.

3. As a result of rights received through an investment vehicle, an investor may gain the ability to exercise significant influence over the operating and financial policies of an investee[2] without holding an investment in voting common stock of the investee. Some believe that existing authoritative literature already addresses an investor's accounting for a number of those arrangements (for example, Statement 115, Statement 133, and SOP 78-9).

4. A similar issue was discussed by the Task Force during the administrative session of the July 23, 1998 EITF meeting. At that time, the Task Force discussed the following question: "If an entity owns noncommon voting securities that provide it with the ability to exert significant influence over an investee, is that entity required to follow the guidance in Opinion 18 (that is, is the equity method of accounting required for an investment in voting preferred stock that provides for a 30 percent voting interest and commensurate board of directors representation)?"[3] At that meeting, the Task Force was not asked to reach a consensus on that issue; rather, it was asked if this, as well as other Opinion 18 implementation questions, should be addressed by the Board in a comprehensive project on unconsolidated investments or by AcSEC as part of its project on unconsolidated real estate investments. No further action was taken by the Task Force; the Opinion 18 implementation questions were incorporated into AcSEC's project on investments in real estate ventures.

Issues

5. The issues are:

Issue 1— Whether an investor should apply the equity method of accounting to investments other than common stock if the investor has the ability to exercise significant influence over the operating and financial policies of the investee

[1] However, the Interpretation also states that "many of the provisions of the Opinion would be appropriate in accounting for investments in these unincorporated entities [partnerships and unincorporated joint ventures]. . . ."
[2] Refer to paragraph 17 of Opinion 18 and paragraph 4 of Interpretation 35.
[3] EITF Agenda Committee background material for May 1998.

Issue 2— If the equity method of accounting applies to investments in other than common stock, how the equity method should be applied to those investments

Issue 3— Whether investments other than common stock that have a "readily determinable fair value" under paragraph 3 of Statement 115 should be accounted for in accordance with Statement 115 rather than pursuant to this Issue.

Prior EITF Discussion

6. At the September 11–12, 2002 EITF meeting, the Task Force requested that the FASB staff develop views regarding (a) the meaning of in-substance common stock for purposes of applying the equity method of accounting and (b) the meaning of other-than-temporary impairment and its application to certain investments carried at cost.

7. At the November 21, 2002 EITF meeting, the Task Force discussed the meaning of in-substance common stock for purposes of applying the equity method of accounting. Certain Task Force members expressed the view that the concept of residual interest should be considered separately from voting rights when evaluating whether the equity method should be applied. The Task Force requested that the FASB staff further develop its views.

8. The Task Force also discussed the meaning of other-than-temporary impairment and its application to certain investments carried at cost. The Task Force requested that the FASB staff consider other impairment models within the framework of generally accepted accounting principles when developing its views. The Task Force also requested that the scope of the impairment issue be expanded to include equity method investments and investments subject to Statement 115 and that that issue be addressed by the Task Force as a separate EITF Issue. [Refer to EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments."]

9. At the January 23, 2003 EITF meeting, the Task Force continued its discussion of the concept of residual interest and how that concept interacts with significant influence. The Task Force agreed that an investor should first determine if its investment is subject to Opinion 18 and then determine if significant influence exists.

10. The Task Force viewed the concept of residual interest as key in evaluating whether an investment is subject to Opinion 18. It was noted that an investor should first determine if its investment has characteristics of a residual interest and, if so, then the investor should determine if it exercises significant influence through any available means. Certain views developed by the FASB staff described certain characteristics of a residual interest—it is an ownership interest conveying certain rights; it is dependent on the enterprise's profitability for distributions of enterprise assets (for example, dividends); and it does not obligate the enterprise to transfer something of value to holders except in the case of liquidation or by formal act. The Task Force requested that the FASB staff refine its views on those characteristics by better defining the type of investment that would qualify as a residual interest subject to the equity method. Task Force members agreed that liquidation preferences and participation rights would be important factors to consider in making that determination. As a consequence of that discussion, a majority of the

Task Force agreed that the equity method should not be strictly limited to investments in voting common stock.

11. Certain Task Force members observed that an investor would first have to evaluate the investee and its investment in the investee under the provisions of Interpretation 46 before applying the provisions of Opinion 18. The Task Force indicated that any guidance provided in this Issue should consider and provide clarification regarding the interaction of this Issue with Interpretation 46.

12. At the March 20, 2003 EITF meeting, the Task Force reached a tentative conclusion on the following model to be applied in determining whether an investment is subject to the equity method of accounting in Opinion 18.

Step 1: Determine if the investor's economic interest[4] is subject to consolidation under ARB 51 or its related interpretations. If the investor's economic interest is deemed to be a controlling financial interest, then the investor would consolidate the investee in accordance with ARB 51 or its related interpretations. If the investor's economic interest is not deemed to be a controlling financial interest, then the investor's economic interest is evaluated under Step 2.

Step 2: Determine if the investor's economic interest meets the residual interest category definition stated below:

> Residual-Interest Category Definition: an ownership interest or a residual-interest, or both,[5] that does not obligate,[6] in and of itself or in combination with other financial instruments, the investee to transfer something of value (for example, assets or ownership interests) to the interest holder (or investor) at a nonspecious future date[7] except in the event of the enterprise's liquidation unless the enterprise formally acts to distribute something of value to owners, for example, by declaring a dividend. Common stock, voting and nonvoting, is an economic interest satisfying this definition; it represents both an ownership interest and a residual interest, and it does not obligate the enterprise to transfer something of value to the interest holder at a future date. However, puttable common stock may or may not obligate the enterprise to transfer something of value at a nonspecious future date depending upon the terms of the embedded put option. Preferred stock—voting or nonvoting, participating or nonparticipating, convertible or nonconvertible—is an economic

[4] Economic interests comprise all types and forms of investment vehicles that an investee could issue or be a party to, including equity securities; financial instruments with characteristics of equity, liabilities, or both; long-term debt and other debt-financing arrangements; leases; and contractual arrangements such as management contracts, service contracts, or intellectual property licenses.

[5] Refer to paragraph 60 of Concepts Statement 6.

[6] *Obligate* is used here in the same sense as in footnote 22 of Concepts Statement 6 and indicates that the enterprise has little or no discretion to avoid (for example, the event is outside the control of the enterprise).

[7] *Specious* is defined as "plausible, apparently sound or convincing, but in reality sophistical or fallacious" (*Oxford English Dictionary*, 1971). The term *nonspecious future date* is included here to preclude certain instruments, such as mandatorily redeemable preferred stock with a 100-year redemption date, from being designed solely to achieve a certain accounting treatment.

interest that satisfies this definition: it represents both an ownership interest and a residual interest,[8] and it does not obligate the enterprise to transfer something of value to the interest holder.[9] Redeemable preferred stock may or may not obligate the enterprise to transfer something of value at a nonspecious future date; it depends on the facts and circumstances of the arrangement.

If the investor's economic interest is not a residual interest (because it does not meet the definition above), then the investor's economic interest is not subject to the equity method of accounting (refer to paragraph 13). If the investor's economic interest is a residual interest, then the investor's economic interest is evaluated under Step 3.

Step 3: Determine if the investor exercises significant influence, by virtue of any means, over operating and financial policies of an investee. The intent of the phrase "by virtue of any means" is that the investor is required to analyze all of its economic interests, including all of its contractual relationships with the investee, regardless of form (for example, side arrangements, oral agreements, and so forth), to determine if the investor exercises significant influence. If the investor does not exercise significant influence, then the investor's residual interest is not subject to the equity method of accounting. If the investor exercises significant influence, then the investor's residual interest is subject to the equity method of accounting.

13. Economic interests that do not meet the residual-interest category definition under the above model generally would not be subject to the equity method of accounting. However, the Task Force also observed that certain economic interests that do not meet the residual-interest category definition might be a result of financial structuring designed to avoid the equity method of accounting. For instance, rather than buying a 30 percent interest in common stock of an investee that would subject the investor to the equity method of accounting, an investor may choose to buy deep-in-the-money warrants (that would convert to a 30 percent interest in common stock of an investee) because warrants would not pass the residual-interest category definition (warrants obligate an investee to transfer something of value[10]). Consequently, if such economic interests are substantially similar to an economic interest that meets the residual-interest category definition in terms of expected residual returns and expected losses and certain other rights, those economic interests would be subject to the equity method of accounting. That determination will be based on the facts and circumstances surrounding the acquisition of the economic interest by the investor.

14. The Task Force directed the FASB staff to develop views on the interaction of the scopes of Statement 115 and Opinion 18 for the purpose of clarifying the scope of this Issue. In particular,

[8] Refer to paragraph 62 of Concepts Statement 6.

[9] While convertible preferred stock would require an entity to issue something of value (issuance of common stock upon conversion of the convertible preferred stock), the potential to convert one form of economic interest that meets the residual interest category definition into another form of economic interest that meets the residual-interest category definition would not cause an economic interest to not meet the residual interest category definition.

[10] Generally, holders of warrants are not entitled to distributions of enterprise assets. When warrants are converted to common stock, the holder would become entitled to distributions of enterprise assets. In contrast, convertible preferred stock is different from a warrant because regardless of exercise, it entitles the holder to distributions of enterprise assets.

the Task Force directed the FASB staff to develop views on whether economic interests (other than voting common stock, which is specifically within the scope of Opinion 18) that meet the residual interest definition in Step 2, above, but that also meet the definition of marketable equity securities under Statement 115, should be accounted for in accordance with Statement 115 rather than this Issue.[11] In addition, the Task Force directed the FASB staff to develop views on the application of the equity method of accounting to investments that meet the residual-interest category definition (except for voting common stock).

15. At the November 12–13, 2003 EITF meeting, the FASB staff recommended that the Task Force remove this Issue from the EITF's agenda based on (a) a literal reading of Opinion 18 that the equity method applies to voting common stock and (b) procedural conflicts that would arise for common stock investors currently applying the equity method procedures under Opinion 18 when those procedures are applied to other classes of securities in addition to common stock. The FASB staff also presented its view that the interaction of Opinion 18 and Statement 115 precludes an investor from applying Statement 115 if the investment is subject to the equity method of accounting.

16. Some Task Force members observed that other authoritative literature (such as Accounting Interpretation 2 of Opinion 18; SOP 78-9; EITF Issues No. 95-6, "Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation," No. 98-13, "Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee," and No. 99-10, "Percentage Used to Determine the Amount of Equity Method Losses"; and *EITF Abstracts*, Topic No. D-46, "Accounting for Limited Partnership Investments") requires the equity method of accounting for investments in instruments other than voting common stock. Those Task Force members also believe that applying the equity method to investments other than voting common stock does not create procedural conflicts for common stock investors. Therefore, the Task Force decided to not remove this Issue from the EITF's agenda but agreed to form a working group to further explore the issues raised by the Task Force for discussion at a future meeting.

17. Pending further development of this Issue, the SEC Observer stated that registrants should continue to use the equity method of accounting when the registrant has significant influence over an investee and holds an investment that is in-substance common stock.

18. At the March 17–18, 2004 EITF meeting, the FASB staff presented the Working Group's recommendation, which was consistent with the Task Force's prior tentative conclusion on Issue 1, that the equity method should be applied to investments in common stock and residual interest category investments other than common stock. However, the Task Force was unable to reach a consensus on that prior tentative conclusion and the Working Group recommendation and decided to discontinue further discussion of the residual-interest category approach.

19. The Task Force discussed the alternative view to Issue 1, that the equity method should be applied to investments in common stock and in-substance common stock. For purposes of that

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[11] This requested scope clarification is not intended to amend in any way the consensus reached in EITF Issue No. 98-13, "Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee."

discussion, the Task Force considered the following revised definition of in-substance common stock:

> An economic interest that has a fair value that is substantially similar to the fair value of common stock. The following characteristics would lead an investor to believe that the economic interest's fair value is substantially similar to the fair value of common stock:
>
> (a) Substantially similar subordination characteristics to those of the common shareholders. For example, a *de minimis* liquidation preference or other non-substantive liquidation preferences would provide substantially similar subordination characteristics to those of the common shareholders.
>
> (b) Expected participation in the investee's earnings that is substantially similar to that of the common shareholders.
>
> (c) The right to convert to common stock.[12]

20. The Task Force was unable to reach a consensus that the equity method should be applied to in-substance common stock category investments, based on the revised definition of in-substance common stock. The Task Force again considered whether to remove this Issue from the agenda but was unable to reach a consensus. Instead, the Task Force asked the FASB staff to further clarify the definition of in-substance common stock, particularly with respect to the notion that "in-substance common stock has a fair value that is substantially similar to the fair value of common stock." The Task Force asked the FASB staff to clarify that *changes* in the fair value of in-substance common stock should be expected to be substantially similar to the changes in the fair value of common stock.

21. Pending further development of this Issue, the SEC Observer reiterated the earlier observation that registrants should continue to use the equity method of accounting when the registrant has the ability to exercise significant influence over an investee and holds an investment that is in-substance common stock. However, the SEC Observer noted that, pending further refinements to the definition of in-substance common stock presented in this Issue, the determination of what constitutes in-substance common stock should be based on an evaluation of all relevant facts and circumstances on a case-by-case basis.

22. The Task Force did not discuss Issues 2 and 3.

23. The illustrations of alternative approaches of applying the equity method to investments in other than common stock (Issue 2) that were presented in Exhibit 02-14A and Exhibit 02-14B to Working Group Report No. 1, for the March 17–18, 2004 EITF meeting, were prepared solely for purposes of discussion by the Task Force. Neither the Task Force nor the FASB staff concluded that any of those approaches are acceptable or unacceptable applications of generally accepted accounting principles.

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[12] Although paragraph 18 of Opinion 18 precludes measuring equity method income or losses based on potentially convertible shares, conversion rights should be considered in determining whether the investor's participation in the investee's earnings is substantially similar to the common shareholders.

Current EITF Discussion

24. At the June 30–July 1, 2004 EITF meeting, the Task Force reached a consensus on Issue 1 that an investor that has the ability to exercise significant influence over the operating and financial policies of the investee should apply the equity method of accounting only when it has an investment(s) in common stock and/or an investment that is in-substance common stock. The Task Force also reached a consensus on the definition of in-substance common stock and related guidance. Those consensuses and the related guidance are described further in the attached draft abstract as Exhibits 02-14A and 02-14B.

25. The FASB staff will add the following in *EITF Abstracts* to the Status sections of Issue 98-13 and Issue 99-10, and to the Subsequent Developments section of Topic D-68:

> At the June 30–July 1, 2004 EITF meeting, the Task Force reached a consensus on Issue No. 02-14, "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock," that for purposes of applying Opinion 18, the term "common stock" includes "in-substance common stock" (as defined under Issue 02-14). Therefore, an investor that has the ability to exercise significant influence over the operating and financial policies of the investee should apply the guidance under this Issue (Topic) only when it has an investment(s) in common stock and/or an investment that is in-substance common stock.

Transition

26. The consensuses in this Issue should be applied in reporting periods beginning after September 15, 2004.

27. For investments in which the investor has the ability to exercise significant influence over the operating and financial policies of the investee, the investor should make an initial determination about whether investments existing as of the date the consensuses are first applied are in-substance common stock; that initial determination should be based on circumstances that exist on the date of adoption of this Issue, rather than on the date that the investment was made.

28. For investments that are in-substance common stock but were not accounted for under the equity method of accounting prior to the consensuses in this Issue, the equity method of accounting should be applied effective for reporting periods beginning after September 15, 2004. The effect of adopting the consensuses in this Issue should be reported in the beginning of the reporting period of adoption similar to a cumulative effect of a change in accounting principle pursuant to Opinion 20. If the determination of the cumulative effect of retroactive application is impracticable, the cumulative effect should be determined as the difference between the investor's carrying amount of the investment and the investor's share of the investee's reported net assets determined in accordance with GAAP as of the date of initial application of the consensuses in this Issue. Pro forma disclosure of the effect of the change in accounting principle in periods presented prior to the initial application of these consensuses is not required.

29. For investments that are not common stock or in-substance common stock, but were accounted for under the equity method of accounting prior to the consensuses in this Issue, the

equity method of accounting should be discontinued effective for reporting periods beginning after September 15, 2004. Previously recognized equity method earnings and losses should not be reversed. The investor should evaluate whether the investment should be prospectively accounted for under Statement 115 or accounted for using the cost method under Opinion 18.

30. The SEC Observer noted that, in the past, the SEC staff has required registrants with significant influence over an investee to apply the equity method to interests that were other than common stock interests in situations in which it was obvious that there were no substantive differences between the instrument and the common stock of the investee. In those situations, the SEC staff has required restatement for correction of an error. The SEC staff will continue to require restatement for correction of an error in those instances.

Board Ratification

31. At its July 16, 2004 meeting, the Board ratified the consensuses reached by the Task Force in this Issue.

Status

32. No further EITF discussion is planned.

Exhibit 02-14A

EITF Abstracts (DRAFT[13])

Issue No. 02-14

Title: Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock

Dates Discussed: September 11–12, 2002; November 21, 2002; January 23, 2003; March 20, 2003; November 12–13, 2003; March 17–18, 2004; June 30–July 1, 2004

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

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

FASB Statement No. 128, *Earnings per Share*

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

FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock*

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

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

APB Opinion No. 20, *Accounting Changes*

AICPA Accounting Interpretation 2, "Investments in Partnerships and Ventures," of APB Opinion No. 18

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

ISSUE

1. In March 1971, the Accounting Principles Board issued Opinion 18 to prescribe accounting standards for common stock investments under the equity method. Paragraph 17 of Opinion 18 states, "… the equity method of accounting for an investment in common stock should also be followed by an investor whose investment in *voting stock* gives it the ability to exercise

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

significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock" (emphasis added). Paragraph 2 of Opinion 18 states that "the Opinion also does not apply to investments in common stock other than those described in the Opinion." By inference, the scope of Opinion 18 is restricted to voting common stock. The scope of Opinion 18 was soon questioned, and, in November 1971, the AICPA issued Interpretation 2 of Opinion 18, which reemphasized that "APB Opinion No. 18 applies only to investments in common stock of corporations…."[14]

2. Since 1971, the type and form of investment vehicles have proliferated beyond those in voting common stock; such investment vehicles include convertible debt, preferred equity securities, options, warrants, interests in unincorporated entities, complex licensing and management arrangements, as well as a host of other financial instruments. These investment vehicles can convey—by contract, articles of incorporation, indenture, or other means—any combination of rights, privileges, or preferences including (a) the right to vote with common stockholders, (b) the right to appoint members of the board of directors, (c) substantive participating rights as described in Issue No. 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights," (d) protective rights as described in Issue 96-16, (e) cumulative and participating dividends, and (f) liquidation preferences.

3. As a result of rights received through an investment vehicle, an investor may gain the ability to exercise significant influence over the operating and financial policies of an investee[15] without holding an investment in voting common stock of the investee. Some believe that existing authoritative literature already addresses an investor's accounting for a number of those arrangements (for example, Statement 115, Statement 133, and SOP 78-9).

4. The issues are:

Issue 1— Whether an investor should apply the equity method of accounting to investments other than common stock

Issue 2— If the equity method should be applied to investments other than common stock, how the equity method of accounting should be applied to those investments

Issue 3— Whether investments other than common stock that have a "readily determinable fair value" under paragraph 3 of Statement 115 should be accounted for in accordance with Statement 115 rather than pursuant to this Issue.

EITF DISCUSSION

5. The Task Force reached a consensus on Issue 1 that an investor that has the ability to exercise significant influence over the operating and financial policies of the investee should apply the equity method of accounting only when it has an investment(s) in common stock and/or an investment that is in-substance common stock. This Issue addresses the determination of whether an investment is in-substance common stock and when to perform that evaluation, but

[14] However, the Interpretation also states that "many of the provisions of the Opinion would be appropriate in accounting for investments in these unincorporated entities [partnerships and unincorporated joint ventures]. . . ."

[15] Refer to paragraph 17 of Opinion 18 and paragraph 4 of Interpretation 35.

does not address the determination of whether an investor has the ability to exercise significant influence over the operating and financial policies of the investee. This Issue does not apply to investments accounted for under Statement 133, non-corporate entities accounted for under SOP 78-9, or to limited liability companies that maintain "specific ownership accounts" for each investor as discussed in Issue No. 03-16, "Accounting for Investments in Limited Liability Companies."

6. The Task Force reached a consensus that in-substance common stock is an investment in an entity that has risk and reward characteristics that are substantially similar to that entity's common stock.[16] An investor should consider the following characteristics when determining whether an investment in an entity is substantially similar to an investment in that entity's common stock. If the investor determines that any one of the following characteristics indicates that an investment in an entity is not substantially similar to an investment in that entity's common stock, the investment is not in-substance common stock.

a. *Subordination*. An investor should determine whether the investment has subordination characteristics that are substantially similar to that entity's common stock. If an investment has a substantive liquidation preference over common stock, it is not substantially similar to the common stock. However, certain liquidation preferences are not substantive. Accordingly, an investor should determine whether a liquidation preference is substantive. For example, if the investment has a stated liquidation preference that is not significant in relation to the purchase price of the investment, the liquidation preference is not substantive. Further, a stated liquidation preference is not substantive if the investee has little or no subordinated equity (for example, common stock) from a fair value perspective. The Task Force believes that a liquidation preference in an investee that has little or no subordinated equity from a fair value perspective is nonsubstantive because, in the event of liquidation, the investment will participate in substantially all of the investee's losses.
b. *Risks and rewards of ownership*. An investor should determine whether the investment has risks and rewards of ownership that are substantially similar to an investment in that entity's common stock. If an investment is not expected to participate in the earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock, the investment is not substantially similar to common stock. If the investee pays dividends on its common stock and the investment participates currently in those dividends in a manner that is substantially similar to common stock, then that is an indicator that the investment is substantially similar to common stock. Likewise, if the investor has the ability to convert the investment into that entity's common stock without any significant restrictions or contingencies that prohibit the investor from participating in the capital appreciation of the investee in a manner that is substantially similar to that entity's common stock, the conversion feature is an indicator that the investment is substantially similar to the common stock. The Task Force observed that the right to convert certain investments to common stock (such as the exercise of deep-in-the-money warrants) enables the interest to participate in the investee's earnings (and losses) and capital appreciation (and depreciation) on a substantially similar basis to common stock.

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[16] Statement 128 defines common stock as a stock that is subordinate to all other stock of the issuer. If an investee has more than one class of common stock, the investor should perform the analysis described in paragraphs 6 and 7 (if necessary) by comparing its investment to all classes of common stock.

c. *Obligation to transfer value*. An investment is not substantially similar to common stock if the investee is expected to transfer substantive value to the investor and the common shareholders do not participate in a similar manner. For example, if the investment has a substantive redemption provision (for example, a mandatory redemption provision or a non-fair value put option) that is not available to common shareholders, the investment is not substantially similar to common stock.[17]

7. If an investment's subordination characteristics and risks and rewards of ownership are substantially similar to the common stock of the investee and the investment does not require the investee to transfer substantive value to the investor in a manner in which the common shareholders do not participate similarly, then the investment is in-substance common stock. If the determination about whether the investment is substantially similar to common stock cannot be reached based solely on the evaluation under paragraph 6, the investor should also analyze whether the future changes in the fair value of the investment are expected to be highly correlated[18] with the changes in the fair value of the common stock. If the changes in the fair value of the investment are not expected to be highly correlated with the changes in the fair value of the common stock, then the investment is not in-substance common stock.

8. The initial determination of whether an investment is substantially similar to common stock should be made on the date on which the investor obtains the investment if the investor has the ability to exercise significant influence over the operating and financial policies of the investee. That determination should be reconsidered if one or more of the following occur:

a. The contractual terms of the investment are changed resulting in a change to any of its characteristics described in paragraphs 6 and 7.[19]
b. There is a significant change in the capital structure of the investee, including the investee's receipt of additional subordinated financing.
c. The investor obtains an additional interest in an investment in which the investor has an existing interest. As a result, the method of accounting for the cumulative interest is based on the characteristics of the investment at the date at which the investor obtains the additional interest (that is, the characteristics that the investor evaluated in order to make its investment decision), and will result in the investor applying one method of accounting to the cumulative interest in an investment of the same issuance.

9. The determination of whether an investment is similar to common stock should not be reconsidered solely due to losses of the investee.

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[17] An obligation to transfer value at a specious future date, such as preferred stock with a mandatory redemption in 100 years, should not be considered an obligation to transfer substantive value under this Issue.

[18] The term "highly correlated" does not have the same meaning in this Issue as it is used in Statement 133 to evaluate hedge effectiveness. The FASB staff believes that the way in which the term is used in this Issue represents a higher level of correlation than the way in which it is used in Statement 133.

[19] An expected change in the contractual terms of an investment that are provided for in the original terms of the contractual agreement should be considered for purposes of the initial determination under paragraph 6, and not as a reconsideration event. However, a change in the form of the investment (for example, debt to equity or preferred stock to another series of stock) is a reconsideration event.

10. If an investor obtains the ability to exercise significant influence over the operating and financial policies of an investee subsequent to the date that the investor obtained the investment, the investor should perform an initial determination, pursuant to paragraphs 6 and 7, using all relevant and necessary information that exists on the date that the investor obtains significant influence.

11. The Task Force was not asked to reach a consensus on Issues 2 and 3. In regard to Issue 3, the Task Force observes that an investor should apply the equity method of accounting in all cases, within the scope of this Issue, in which an investor has the ability to exercise significant influence over the operating and financial policies of the investee and owns common stock or in-substance common stock of the investee.

12. The Task Force also observes that it did not address consolidation accounting pursuant to ARB 51 and its related amendments and interpretations or the determination of earnings per share pursuant to Statement 128 and its related amendments and interpretations in this Issue.

Transition

13. The consensuses in this Issue should be applied in reporting periods beginning after September 15, 2004.

14. For investments in which the investor has the ability to exercise significant influence over the operating and financial policies of the investee, the investor should make an initial determination about whether investments existing as of the date the consensuses in this Issue are first applied are in-substance common stock; that initial determination should be based on circumstances that exist on the date of adoption of this Issue, rather than on the date that the investment was made.

15. For investments that are in-substance common stock but were not accounted for under the equity method of accounting prior to the consensuses in this Issue, the equity method of accounting should be applied effective for reporting periods beginning after September 15, 2004. The effect of adopting the consensuses in this Issue should be reported in the beginning of the reporting period of adoption similar to a cumulative effect of a change in accounting principle pursuant to Opinion 20. If the determination of the cumulative effect of retroactive application is impracticable, the cumulative effect should be determined as the difference between the investor's carrying amount of the investment and the investor's share of the investee's reportable net assets determined in accordance with GAAP as of the date of initial application of the consensuses in this Issue. Pro forma disclosure of the effect of the change in accounting principle in periods presented prior to the initial application of these consensuses is not required.

16. For investments that are not common stock or in-substance common stock, but were accounted for under the equity method of accounting prior to the consensuses in this Issue, the equity method of accounting should be discontinued effective for reporting periods beginning after September 15, 2004. Previously recognized equity method earnings and losses should not be reversed. The investor should evaluate whether the investment should be prospectively accounted for under Statement 115 or accounted for using the cost method under Opinion 18.

17. The SEC Observer noted that, in the past, the SEC staff has required registrants with significant influence over an investee to apply the equity method to interests that were other than common stock interests in situations in which it was obvious that there were no substantive differences between the instrument and the common stock of the investee. In those situations, the SEC staff has required restatement for correction of an error. The SEC staff will continue to require restatement for correction of an error in those instances.

Board Ratification

18. At its July 16, 2004 meeting, the Board ratified the consensuses reached by the Task Force in this Issue.

STATUS

19. No further EITF discussion is planned.

Exhibit 02-14B

EXAMPLES OF THE APPLICATION OF THE CHARACTERISTICS OF IN-SUBSTANCE COMMON STOCK

The following examples illustrate the application of the characteristics described in paragraph 6 to various investments. Each example provides sufficient information to reach a conclusion about whether the investment contemplated in the example has the characteristic of in-substance common stock being demonstrated in the example. In each example, assume that the investor is performing the analysis because it has determined that it is not required to consolidate the investee under ARB 51 or its related interpretations, that it has the ability to exercise significant influence over the operating and financial policies of the investee, and that its investment does not meet the definition of a derivative under Statement 133.

Example 1 – Application of Paragraph 6(a); Subordination

Investor A organized Investee and acquired all of the common stock of Investee on January 1, 2003. On January 1, 2004, Investee sells 100,000 shares of preferred stock to a group of investors in exchange for $10,000,000 ($100 par value; liquidation preference of $100 per share). The fair value of the entity's common stock is approximately $100,000 on January 1, 2004.

In this example, the stated liquidation preference is equal to the fair value of the preferred stock. However, the fair value of the common stock ($100,000), when compared with the fair value of the preferred stock, indicates that Investee has little or no common stock from a fair value perspective. An investor should therefore conclude that the liquidation preference is not substantive and that the subordination characteristics of its preferred stock investment are substantially similar to the subordination characteristics of Investee's common stock. The investor should also evaluate whether the preferred stock has the characteristics in paragraphs 6(b), 6(c), and 7 (if necessary) in order to reach a conclusion about whether the preferred stock is in-substance common stock.

Example 2 – Application of Paragraph 6(a); Subordination

Assume the same facts and circumstances as in Example 1, except that the fair value of Investee's common stock is approximately $15,000,000 on January 1, 2004.

In this example, the stated liquidation preference is equal to the fair value of the preferred stock. In addition, Investee has adequate subordinated equity from a fair value perspective (more than little or no subordinated equity) to indicate that the liquidation preference is substantive. An investor therefore should conclude that the subordination characteristics of its preferred stock investment are not substantially similar to the subordination characteristics of Investee's common stock. Accordingly, the preferred stock investment is not in-substance common stock. Evaluation of the characteristics in paragraphs 6(b), 6(c), and 7 is not required.

Example 3 – Application of Paragraph 6(b); Participation in Risks and Rewards of Ownership

Investor purchases a warrant in Investee for $2,003,900 on July 1, 20X4. The warrant enables Investor to acquire 100,000 shares of Investee's common stock at an exercise price of $1.00 per share (total exercise price of $100,000) on or before June 30, 20X5; the warrant does not participate in dividends. The fair value of the common stock is approximately $21.00 per share. The warrant is exercisable at any time. Investor does not expect Investee to declare dividends prior to exercise.

Investor should evaluate whether the warrant is expected to participate in Investee's earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock. In order to evaluate the extent to which the warrant is expected to participate with the common shareholders in Investee's earnings (and losses), Investor should evaluate whether the warrant allows Investor to currently participate in dividends on a basis substantially similar to common stock. In this example, Investor does not participate in dividends. Investor, however, can exercise the warrant (convert into common stock) at any time, thereby enabling Investor to participate in Investee's earnings (and losses) on an equivalent basis to common stock. Since Investor does not expect Investee to declare dividends prior to exercise, Investor participates in Investee's earnings in a manner substantially similar to common stock. In addition, warrants that are exercisable into common stock are designed to participate equally with the common shareholders in increases in the Investee's fair value. Therefore, the warrant participates in Investee's capital appreciation.

Investor should also evaluate whether the warrant is expected to participate in Investee's capital depreciation in a manner substantially similar to common stock. An investor has alternatives for making this evaluation. In this example, Investor could compare the current fair value of Investee's common stock with the fair value of the warrant (on an equivalent unit basis) to determine whether the warrant is exposed to capital depreciation in a manner that is substantially similar to the entity's common stock.[20] The current fair value of the Investee's common stock of $21.00 is substantially similar to the current fair value of each warrant of $20.04 (on an equivalent unit basis). Therefore, the warrant's expected participation in Investee's capital depreciation is substantially similar to the common shareholders' participation.

Accordingly, Investor should conclude that, prior to exercise, the warrants are expected to participate in Investee's earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock. The investor should also evaluate whether the warrant has the characteristics in paragraphs 6(a), 6(c), and 7 (if necessary) in order to reach a conclusion about whether the warrant is in-substance common stock.

[20] This comparison of fair values is different from the paragraph 7 evaluation that is performed (if necessary) to determine whether the future changes in fair value of the investment are expected to be highly correlated with the changes in the fair value of the entity's common stock.

Example 4 – Application of Paragraph 6(b); Participation in Risks and Rewards of Ownership
Investor purchases a warrant in Investee for $288,820 on July 1, 20X4. The warrant enables Investor to acquire 100,000 shares of Investee's common stock at an exercise price of $21.00 per share (total exercise price of $2,100,000) on or before June 30, 20X5; the warrant does not participate in dividends. The fair value of the common stock is approximately $21.00 per share. The warrant is exercisable at any time. Investor does not expect Investee to declare dividends prior to exercise.

Investor should evaluate whether the warrant is expected to participate in Investee's earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock. In order to evaluate the extent to which the warrant is expected to participate with the common shareholders in Investee's earnings (and losses), Investor should evaluate whether the warrant allows Investor to currently participate in dividends on a basis substantially similar to common stock. In this example, Investor does not participate in dividends. Investor, however, can exercise the warrant (convert into common stock) at any time, thereby enabling Investor to participate in Investee's earnings (and losses) on an equivalent basis to common stock. Since Investor does not expect Investee to declare dividends prior to exercise, Investor participates in Investee's earnings in a manner substantially similar to common stock. In addition, warrants that are exercisable into common stock are designed to participate equally with the common shareholders in increases in Investee's fair value. Therefore, the warrant participates in Investee's capital appreciation.

Investor should also evaluate whether the warrant is expected to participate in Investee's capital depreciation in a manner substantially similar to common stock. An investor has alternatives for making this evaluation. In this example, Investor could compare the current fair value of Investee's common stock with the current fair value of the warrant (on an equivalent unit basis) to determine whether the warrant is exposed to capital depreciation in a manner that is substantially similar to the entity's common stock.[21] The current fair value of the Investee's common stock of $21.00 is substantially different from the current fair value of each warrant of $2.88 (on an equivalent unit basis). Therefore, the warrant's expected participation in Investee's capital depreciation is substantially different from the common shareholders' participation.

Accordingly, Investor should conclude that, prior to exercise, the warrants are not expected to participate in Investee's earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock and, accordingly, the warrants are not in-substance common stock. Evaluation of the characteristics in paragraphs 6(a), 6(c), and 7 is not required.

Example 5 – Application of Paragraph 6(c); Investee's Obligation to Transfer Value
Investor purchases redeemable convertible preferred stock in Investee for $2,000,000. The investment can be (a) converted into common stock valued at $2,000,000 or (b) redeemed for

[21] This comparison of fair values is different from the paragraph 7 evaluation that is performed (if necessary) to determine whether the future changes in fair value of the investment are expected to be highly correlated with the changes in the fair value of the entity’s common stock.

$10,000 at the option of the Investor. The common shareholders do not have a similar redemption feature.

Investor should evaluate whether exercise of the $10,000 redemption feature obligates Investee to transfer substantive value to Investor and whether the common shareholders do not participate in a similar manner. In this example, the $10,000 redemption feature is not substantive. Accordingly, Investor should conclude that redeemable convertible preferred stock does not require Investee to transfer substantive value to the investor and that common shareholders do not participate. Investor should also evaluate whether the redeemable convertible preferred stock has the characteristics in paragraphs 6(a), 6(b), and 7 (if necessary) in order to reach a conclusion about whether the redeemable convertible preferred stock is in-substance common stock.

Example 6 – Application of Paragraph 6(c); Investee's Obligation to Transfer Value

Investor purchases redeemable convertible preferred stock in Investee for $2,000,000. The investment can be (a) converted into common stock valued at $2,000,000 or (b) redeemed for $2,000,000 at the option of the Investor. The common shareholders do not have a similar redemption feature. Investor expects that Investee will have the ability to pay the redemption amount.

Investor should evaluate whether exercise of the $2,000,000 redemption feature obligates Investee to transfer substantive value to Investor and whether the common shareholders do not participate in a similar manner. In this example, the $2,000,000 redemption feature is substantive because (a) the redemption amount is substantive as compared to the fair value of the investment and (b) based on Investor's expectation as of the date that the investment was made, Investee has the ability to pay the redemption amount.

Accordingly, Investor should conclude that redeemable convertible preferred stock requires Investee to transfer substantive value to Investor and that common shareholders do not participate. Accordingly, the redeemable convertible preferred stock is not in-substance common stock. Evaluation of the characteristics in paragraph 6(a), 6(b), and 7 is not required.

Issue No. 03-9

Title: Determination of the Useful Life of Renewable Intangible Assets under FASB Statement No. 142, *Goodwill and Other Intangible Assets*

Dates Discussed: July 31, 2003; November 12–13, 2003; March 17–18, 2004; June 30–July 1, 2004

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

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

Introduction

1. This Issue addresses how the pertinent factors in subparagraph 11(d) of Statement 142 should be evaluated in determining whether an intangible asset, in which a marketplace participant anticipates renewal (hereinafter referred to as a "renewable intangible asset"), has an indefinite useful life.

2. Paragraph B174 of Statement 141 states that judgment is required in determining the period over which future cash flows should be expected for purposes of determining the fair value of an intangible asset. Those estimates of future cash flows should incorporate assumptions that marketplace participants would use in making estimates of fair value, such as assumptions about future contract renewals *and* other benefits such as those that might result from acquisition-related synergies. In cases in which contractual or legal rights are routinely renewed, estimates of future cash flows should extend beyond the remaining contractual or legal term.

3. Statement 142 provides guidance that could define the useful life of a renewable intangible asset different from the useful life that would be derived solely from the guidance in Statement 141. Paragraph 11 of Statement 142 requires an entity to assess whether certain "pertinent factors" limit a useful life of an intangible asset to the reporting entity (that is, whether the pertinent factors limit the period over which an asset is expected to contribute directly or indirectly to future cash flows). In particular, paragraph 11(d) of Statement 142 states that an entity should consider "any legal, regulatory, or contractual provisions that enable renewal or extension of the asset's legal or contractual life without *substantial cost* (provided there is evidence to support renewal or extension and renewal or extension can be accomplished without *material modifications* of the existing terms and conditions" (emphasis added).

Issue

4. The issues are:

Issue 1— When considering whether renewal of a contractual or legal right giving rise to an intangible asset requires "substantial cost" pursuant to paragraph 11(d) of Statement 142, the expenditures that should be considered to be a "cost" of the renewal or extension

Issue 2— When analyzing the pertinent factors contained in paragraph 11(d) of Statement 142, the "existing terms and conditions" that may be subject to change upon renewal or extension that are subject to the "material modifications" consideration

Issue 3— Whether limiting factors exist that could result in a useful life for amortization purposes that is shorter than the useful life for asset valuation purposes

Issue 3(a)— If there are limiting factors that could result in a shorter useful life for amortization purposes than those used for asset valuation purposes, *how* those limiting factors should be taken into consideration in the determination of the intangible asset's useful life

Issue 4— Whether the intangible asset that is recognized apart from goodwill pursuant to paragraph 39 of Statement 141 is appropriately defined.

Prior EITF Discussion

5. At the July 31, 2003 EITF meeting, the Task Force discussed Issue 1 and generally agreed that the analysis of whether the useful life of an intangible asset should extend beyond its contractual term should be based on assumptions of renewal or nonrenewal that are consistent with assumptions of marketplace participants. The Task Force noted that the useful life—the period over which an intangible asset is expected to contribute to an entity's cash flows—for amortization purposes should be consistent with the estimated useful life considerations used in the determination of the fair value of that asset.

6. Task Force members noted that, in many cases, the fair value of the intangible asset is determined using probability-weighted expected future cash flows and, therefore, it may be difficult to discern a single point estimate for the useful life for amortization purposes. Some Task Force members also observed that it may be difficult to differentiate an intangible asset with a relatively long, but *finite*, life from an intangible asset with an *indefinite* life. In the course of that discussion, some Task Force members also noted that linking the amortization period to the estimated useful life considerations used in the valuation model may indicate that straight-line amortization does not best reflect the pattern in which the economic benefits of the intangible asset are consumed. The Task Force directed the FASB staff to further explore those issues for discussion at a future meeting.

7. At the November 12–13, 2003 EITF meeting, the Task Force considered an example fact pattern that was prepared by the FASB staff along with various valuation scenarios that were designed to illustrate the application of the "pattern-of-economic-benefit" amortization method for renewable intangible assets. Those illustrations indicate that for the same intangible asset, depending on the pattern of economic benefits implied by the valuation of the asset, the amount and timing of the amortization of the cost of the asset could be dramatically different. However, the FASB staff believes that such a result is consistent with the provisions of paragraph 12 of Statement 142, which states, in part, that "the method of amortization shall reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method shall be used."

8. The FASB staff's proposed approach suggested that for purposes of determining the *pattern in which the economic benefits of the intangible asset are consumed*, the undiscounted cash flows included in the valuation model for any given period would be compared with the sum of the undiscounted cash flows over that same period to develop the ratio of the fair value of the asset that would be amortized during that period. Otherwise, the time value of money would impact the amortization pattern resulting in a downward-sloping amortization curve even when the pattern of benefit is uniform.

9. The Task Force was not asked to reach a consensus on the FASB staff's proposed model noting that the proposed approach would result in most intangible assets subject to amortization being amortized using the "pattern of economic benefit" method rather than the straight-line method. The Task Force also noted that the implication of that approach is that the guidance in paragraph 11 of Statement 142 is, in many cases, obviated by the decisions that are required in determining the fair value of intangible assets pursuant to Statement 141.

10. As a result of those concerns, the Task Force requested that the FASB staff form a working group to explore further those issues that have arisen in practice. In particular, those issues surround (a) the determination of the useful life of an intangible asset that is subject to legal, regulatory, or contractual limits, (b) the determination of when an intangible asset may be determined to have an indefinite life, and (c) how to interpret the provisions of paragraph 12 of Statement 142 regarding the determination of *the pattern in which the economic benefits are consumed* and whether that pattern can be *reliably determined*.

11. At the March 17–18, 2004 EITF meeting, the FASB staff presented the practice issue identified by the Working Group: determining the useful life of intangible assets that have contractual provisions that enable renewal or extension. The Working Group also identified three possible approaches to addressing that issue: (a) set the useful life of the intangible asset for amortization purposes equal to the period over which the entity projects that the intangible asset will contribute to its cash flows, (b) refine the definition of the intangible asset that is recognized apart from goodwill under Statement 141 (Issue 4), and (c) restrict the useful life of the intangible asset for amortization purposes to a period shorter than the period over which the entity projects that the intangible asset will contribute to its cash flows based on the probability that the asset may not be renewed (Issue 3 and Issue 3(a)).

12. The Task Force discussed Issue 4 and questioned whether the practice issue is caused by (a) a difficulty in distinguishing indefinite-lived intangible assets from finite-lived intangible assets and/or (b) an inability to determine whether the intangible asset consists of a single asset (for example, the contractual right to use a patented technology for the contractual term of the license agreement remaining at the date of acquisition) or multiple assets including the base contractual asset and one or more additional intangible assets (for example, the supplier relationship—that is, rights to negotiate renewals at the end of each contractual term—and/or renewal options). The Task Force was not asked to reach a consensus on Issue 4 but directed the FASB staff to consider those questions for further discussion by the Task Force.

13. The Task Force did not discuss Issue 3 or Issue 3(a).

Current EITF Discussion

14. At the June 30–July 1, 2004 EITF meeting, the Task Force discussed how substantial costs and material modifications should be evaluated for determining whether a renewable intangible asset is in substance a single asset. The Task Force generally agreed that a renewable intangible asset is in substance a single asset if renewal is reasonably assured. Further, the Task Force generally agreed that an entity should evaluate substantial costs and material modifications when evaluating whether renewal is reasonably assured.

15. The Task Force discussed the meaning of *substantial costs*, and generally agreed that the costs that an entity should evaluate are those expected renewal costs that the entity would not otherwise incur if the contract was not subject to renewal. The Task Force discussed whether the timing of the cash flows should be a factor in the determination of whether the renewal costs are significant. Further, the Task Force noted that paragraph B60 of Statement 142 requires an entity to evaluate significance by comparing those expected renewal costs to the fair value of the renewable intangible asset. The Task Force also discussed the meaning of *material modification*.

16. The Task Force was not asked to reach a consensus but directed the FASB staff to further develop the meaning of substantial costs and material modification for the Task Force's consideration.

Status

17. Further discussion is expected at a future meeting.

Issue No. 03-13

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

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

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

Introduction

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

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

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

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

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

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

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

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

a. The entity retains an interest in the disposal component sufficient to enable it to exert significant influence over the component's operating and financial policies.
b. The entity and the buyer are parties to a significant contract or agreement, such as the relationship between a customer and a supplier, when one entity provides management services to another, or when two entities enter into a transitional support agreement that involves the disposal component. The determination as to whether this constitutes significant continuing involvement should be based on the following factors:

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

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

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

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

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

Issue

9. The issues are:

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

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

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

Prior EITF Discussion

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

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

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

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

14. The proposed approach for assessing whether the entity will have any significant continuing involvement in the operations of the component after the disposal transaction focuses on whether the entity has (a) the ability to influence the operating and/or financial policies of the disposed component, (b) retained risk associated with the operations of the disposed component, or (c) the ability to restrict other third parties from obtaining benefits from the disposed component.

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

requested that the FASB staff develop additional examples for specific fact patterns raised by some Task Force members.

Current EITF Discussion

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

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

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

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

Status

20. Further discussion is expected at a future meeting.

Issue No. 04-1

Title: Accounting for Preexisting Relationships between the Parties to a Business Combination

Dates Discussed: March 17–18, 2004; June 30–July 1, 2004

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

FASB Statement No. 141, *Business Combinations*

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

Introduction

1. This Issue addresses the accounting for a preexisting relationship in a business combination. Specifically, the Issue is whether a business combination between two parties with a preexisting relationship should be evaluated to determine if a settlement of a preexisting relationship exists and, the appropriate accounting for the preexisting relationship.

Issues

2. The issues are:

Issue 1— Whether a business combination between two parties that have a preexisting relationship should be evaluated to determine if a settlement of a preexisting contractual relationship exists, thus requiring accounting separate from the business combination

Issue 2— If separate accounting is required for the settlement of a preexisting relationship between two parties to a business combination, the measurement and recognition of the settlement amount

Issue 3— Whether the acquirer should recognize, apart from goodwill, an acquired entity's intangible asset that, before the business combination, arose solely from the acquired entity's contractual right to use the acquirer's existing recognized or unrecognized intangible assets.

Prior EITF Discussion

3. At the March 17–18, 2004 EITF meeting, the Task Force reached a tentative conclusion on Issue 1 that a business combination between two parties that have a preexisting relationship should be evaluated to determine if a settlement of a preexisting relationship exists. The Task Force observed that a business combination between two parties that have a preexisting relationship could be viewed as a multi-element transaction with one element being the business combination and the other element being the settlement of the preexisting relationship.

4. The Task Force discussed Issue 2 but was not asked to reach a consensus. The Task Force directed the FASB staff to explore further alternative views on the recognition and measurement of the settlement of the preexisting relationship.

5. The Task Force did not discuss Issue 3.

Current EITF Discussion

6. At the June 30–July 1, 2004 EITF meeting, the Task Force discussed the following model that was proposed by the FASB staff to address Issue 2. The model reflects two general principles: (a) the recognition and measurement of the identifiable assets and liabilities of the acquired entity should be based on fair value (a marketplace participant view) and (b) the accounting recognition for the preexisting relationship generally should be the same whether within a business combination or absent a business combination.

<u>Step 1</u>: Allocate the cost of the acquired entity to the identifiable assets acquired and liabilities assumed (including any identifiable assets and liabilities related to the preexisting relationship) based on their estimated fair values at the date of the acquisition with any residual recognized as goodwill in accordance with Statement 141.

<u>Step 2:</u> Segregate the identifiable assets and liabilities related to the preexisting relationship.

<u>Step 3:</u> For each asset (liability) identified in Step 2, determine how the amount allocated to each asset (liability) in Step 1 would be recognized had that amount been paid (incurred) absent the business combination.

7. The Task Force discussed the model and directed the FASB staff to further explore alternative views for the recognition and measurement of the settlement of a preexisting relationship in a business combination.

8. The Task Force did not discuss Issue 3.

Status

9. Further discussion is expected at a future meeting.

Issue No. 04-5

Title: Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights

Date Discussed: June 30–July 1, 2004

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

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

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

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

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

APB Opinion No. 20, *Accounting Changes*

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

Introduction

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

Issue

2. The issue is what rights held by the limited partner(s) preclude consolidation of the limited partnership by the sole general partner.

Current EITF Discussion

3. At the June 30–July 1, 2004 EITF meeting, the Task Force discussed the general direction and approach for addressing which rights held by a limited partner(s) would preclude consolidation of a limited partnership by the sole general partner. The Task Force agreed that the framework developed by the Working Group for EITF Issue No. 98-6, "Investor's

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

Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Approval or Veto Rights," is an appropriate starting point for this Issue, including the presumption that a sole general partner should consolidate a limited partnership absent certain rights held by the limited partner(s). A Task Force member noted that the scope of this Issue should be limited to those limited partnerships with a single general partner or limited partnerships with multiple general partners only if all the general partners are related parties. The Task Force provided the FASB staff with a general direction for developing this Issue.

Status

4. Further discussion is expected at a future meeting.

Issue No. 04-6

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

Date Discussed: June 30–July 1, 2004

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

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

FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*

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

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

AICPA Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*

APB Opinion No. 20, *Accounting Changes*

AICPA Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*

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

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

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

Introduction

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

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

Definition of the Production Phase
3. This Issue applies to the accounting for stripping costs incurred in the production phase of a mining operation. It is often difficult to determine when development or construction of the mine has ended and the production phase has begun. For purposes of defining the scope of this Issue, the definition of the production phase of a mine is as follows:

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

Issue
4. The issue is what the accounting for stripping costs incurred during production should be.

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

Status
6. Further discussion is expected at a future meeting.

Issue No. 04-7

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

Date Discussed: June 30–July 1, 2004

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

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

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

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

Introduction

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

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

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

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

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

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

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

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

Issues

7. The issues are:

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

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

Current EITF Discussion

8. At the June 30–July 1, 2004 EITF meeting, the Task Force discussed the four potential approaches described in paragraph 5, above, and some of the attributes inherent in those approaches. During the discussion, a fifth approach that incorporates the attributes of the combination approach and the by-design approach was introduced. The Task Force was not asked to reach a consensus on Issue 1. The Task Force asked the FASB staff and the Working Group to further develop the fifth approach and to include examples for each of the five potential approaches for discussion at a future meeting. The Task Force did not discuss Issue 2.

Status

9. Further discussion is expected at a future meeting.

Issue No. 04-8

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

Date Discussed: June 30–July 1, 2004

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

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

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

FASB Staff Position No. FAS 129-1, "Disclosure Requirements under FASB Statement No. 129, *Disclosure of Information about Capital Structure*, Relating to Contingently Convertible Securities"

Introduction

1. Contingently convertible debt instruments, commonly referred to as Co-Cos, are financial instruments that add a contingent feature to a convertible debt instrument. Co-Cos are generally convertible into common shares of the issuer after the common stock price has exceeded a predetermined threshold for a specified time period (market price trigger). Currently, most issuers of Co-Cos exclude the potential dilutive effect of the conversion feature from diluted EPS until the market price contingency is met. Co-Cos generally carry a lower interest rate than conventional, nonconvertible debt and, in some structures, permit the issuer to recognize little or no interest costs.

2. While the terms of Co-Cos can vary based on an issuer's specific facts and circumstances, a typical Co-Co includes a contingent market price trigger that exceeds a specified conversion price of the issuer's underlying stock price by a certain percentage (usually 110 percent, 120 percent, or 130 percent) on the date of issuance. Some Co-Cos have floating market price triggers under which conversion is dependent upon the market price of the stock exceeding the conversion price by a certain percentage(s) at specified times during the life of the debt. Other Co-Cos require the market price trigger to be sustained for a specified period, for example, 20 percent above the conversion strike price for a 30-day period. In addition, Co-Cos may have many additional features such as parity features, issuer call options, and investor put options.

3. A Co-Co usually has a conversion price that exceeds the market price of the underlying stock at its issuance date and a market price trigger that exceeds the conversion price. For example, assume a Co-Co is issued for $1,000 and is convertible into 10 shares of common stock. A typical relationship of the relevant prices is as follows:

- Common stock price at Co-Co's issuance date—$80
- Implied conversion price—$100 ($1,000/10 shares into which the debt converts)
- "Market price trigger" permitting conversion—$120.

The market price trigger is higher than the conversion price and, accordingly, the instrument is less likely to be converted than a conventional convertible debt instrument without the market price trigger. Most issuers do not include the dilutive effect of the instrument in diluted EPS unless the market price trigger had been achieved—that is, the market price of the common stock exceeded $120 for the specified period. In contrast, if the instrument did not include the market price trigger, the dilutive effect of the instrument would have been included in diluted EPS on an if-converted basis from the date that the instrument was issued (even though the stock price may not have exceeded the implied conversion price). As illustrated in this example, a Co-Co is likely to be less dilutive in the EPS computation than a noncontingent convertible debt instrument.

Issue

4. The Issue is when the dilutive effect of contingently convertible debt investments (Co-Cos) should be included in diluted earnings per share.

Current EITF Discussion

5. At the June 30–July 1, 2004 EITF meeting, the Task Force reached a tentative conclusion that Co-Cos should be included in diluted earnings per share computations (if dilutive) regardless of whether the market price trigger (or other contingent feature) has been met. That is, Co-Cos are not contingently issuable shares (paragraphs 30–35 of Statement 128) or contingently issuable potential common shares (paragraph 35 of Statement 128) because the Co-Cos have already been issued and are outstanding. Accordingly, Co-Cos should be accounted for as convertible debt pursuant to paragraphs 26–28 of Statement 128 for purposes of calculating diluted EPS.

6. The Task Force agreed that the tentative conclusion would be applied by restating previously reported diluted earnings per share. If the Task Force reaches a final consensus at the September 29–30, 2004 EITF meeting, the Task Force will then consider whether that consensus should be effective for reporting periods ending after December 15, 2004.

7. The Task Force also agreed that a draft abstract should be posted to the FASB's website. The Task Force will consider any comments on that draft abstract at the September 29–30, 2004 EITF meeting.

Status

8. The draft abstract was posted to the FASB's website on July 19, 2004, for a 45-day comment period. Further discussion is expected at a future meeting.

Status of Open Issues and Agenda Committee Items

The following represents the FASB staff's assessment of the status and immediate plans with respect to the open Issues on the Task Force's agenda. The Issues on the proposed agenda for the September 29–30, 2004 meeting are considered either high priority issues or issues on which meaningful progress can be made within the staff's given complement of resources. The staff's prioritization of issues is based primarily on the FASB staff's understanding of the level of diversity in practice created by each respective Issue, the financial reporting implications of that diversity, the current interaction, if any, of the Issues with active Board projects, and current resource availability among the staff (with respect to both time and relevant technical expertise).

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
03-9	Determination of the Useful Life of Renewable Intangible Assets under FASB Statement No. 142, *Goodwill and Other Intangible Assets*	5/03	7/03, 11/03, 3/04, 6/04	9/04	McBride Westerlund Pinson	FASB staff to prepare an issue summary based on Task Force input about whether a renewable intangible asset has an indefinite life and whether it should be recognized as a separate asset.	Draft Issue Summary before September.
03-13	Applying the Conditions in Paragraph 42 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in Determining Whether to Report Discontinued Operations	5/03	11/03, 3/04, 6/04	9/04	Sogoloff Larson	FASB staff to further refine and articulate how an entity should evaluate the nature of cash flows in the proposed approach based on Task Force input.	Draft Issue Summary before September.

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
04-1	Accounting for Preexisting Relationships between the Parties to a Business Combination	01/04	3/04, 6/04	9/04	Munro McBride	FASB staff to prepare a revised Issue Summary that explores alternatives for recognition and measurement based on Task Force input.	Draft Issue Summary before September.
04-5	Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights	5/04	6/04	9/04	Larson O'Callaghan	FASB staff to prepare an issue summary based on the framework developed for EITF Issue No. 98-6, "Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Approval or Veto Rights."	September meeting materials
04-6	Accounting for Stripping Costs Incurred during Production in the Mining Industry	11/03	6/04	9/04	Larson Westerlund	FASB staff to prepare Issue Summary with assistance from the Mining Industry Working Group.	September meeting materials
04-7	Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity	5/04	6/04	9/04	Laurenzano Sogoloff	FASB staff to prepare an Issue Summary with assistance from the Working Group.	September meeting materials

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
04-8	The Effect of Contingently Convertible Debt on Diluted Earnings per Share	5/04	6/04	9/04	O'Callaghan Laurenzano	The FASB staff posted a draft abstract to the FASB website on July 19 for public comment. The Task Force will consider the comments received at the September meeting.	September meeting materials
04-E	The Meaning of Similar Economic Characteristics When Aggregating Operating Segments Including Those Segments That Do Not Meet the Quantitative Thresholds (Items 5 and 6 in the May 26, 2004 Agenda Committee Report)	5/04	N/A	9/04	Sogoloff McBride	The FASB staff will prepare an Issue Summary for the September 2004 meeting.	September meeting materials

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

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

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	**Description**	**Date Added**	**Date(s) Discussed**	**Next Meeting**	**FASB Staff**	**Immediate Plans**	**Due Date - Next Deliverable**
03-17	Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity's Balance Sheet	5/03	11/03	Not scheduled	McBride O'Callaghan	Issues identified at the November 2003 meeting with respect to executory contracts that are partially recognized based on a differential value compared to a benchmark (for example, market price at date of acquisition) and the possibility of negative amortization to be explored by the Working Group on Issue 03-9.	Pending develop-ments in Issue 03-9.

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