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FINANCIAL ACCOUNTING STANDARDS BOARD
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February 6, 2003

TO: MEMBERS OF THE FASB EMERGING ISSUES TASK FORCE

Included are the final minutes of the January 23, 2003 meeting of the FASB Emerging Issues Task Force, (a marked version of the January 28, 2003 draft is also being provided to EITF members only), an inventory of open issues, and synopses of those issues for the next EITF meeting. After your review, please discard the confidential marked version of the minutes. An updated statistical summary of EITF Issues will be made available on the FASB Website.

Issue 00-21 Scope Paragraph
Notwithstanding the proposed revisions to paragraph 4(a) of Issue 00-21 included in the draft minutes, the FASB staff continues to receive questions from Task Force members regarding the appropriate application of the Issue 00-21 scope provisions and, in particular, the interaction of Issue 00-21 with SOP 81-1. That is, based on comments received during the minutes process, it is evident that there is a need for the FASB staff to further refine the language in paragraph 4(a) of that Issue to enable the Task Force to finalize that language at the March meeting. As such, in lieu of revisions to paragraph 4(a), the minutes reflect, in the Administrative Matters section, that the Task Force asked the FASB staff to further develop those revisions for discussion at the next meeting and to specifically consider the interaction of Issue 00-21 with SOP 81-1.

Transition on Issue 1 of Issue 02-16
Based on responses from Task Force members regarding transition on Issue 1 of Issue 02-16, the final transition provided in the attached minutes indicates that the transition guidance provided at the November 21, 2002 meeting has been rescinded and that the consensus on Issue 1 should be applied prospectively to new arrangements, or modifications to existing arrangements, entered into after December 31, 2002. Please refer to the minutes for a complete understanding of related transition guidance.

Meeting Time and Location
The next EITF meeting will be held on **Thursday, March 20, 2003**, at the FASB offices in Norwalk, Connecticut. At this time, the FASB staff believes that a one day meeting will be sufficient to cover related discussion materials. The meeting will start at **8:00 a.m.** and conclude no later than **4:00 p.m.**

EITF Agenda Committee Materials
Descriptions of proposed issues and any other items for EITF consideration should be submitted by no later than **Monday, February 17, 2003 (Washington's Birthday)**, so that they may be considered by the EITF Agenda Committee and then distributed to Task Force members sufficiently in advance of the meeting.

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

Draft minutes available	**March 25, 2003**
Final minutes available	**April 3, 2003**

Please call me at extension 229 if you have any questions.

Sincerely,

James N. Parrott
Practice Fellow

0103FN

MINUTES OF THE JANUARY 23, 2003 OPEN MEETING OF THE FASB EMERGING ISSUES TASK FORCE

Location: FASB Offices
401 Merritt 7
Norwalk, Connecticut

Thursday, January 23, 2003

Starting Time:	8:00 a.m.
Concluding Time:	4:00 p.m.

Task Force Members Present:
Lawrence W. Smith (Chairman)
Jack T. Ciesielski
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.
* David H. Sidwell (By telephone)
Richard H. Stock
Mark V. Sever (AcSEC Observer)

Task Force Members Absent:
Frank H. Brod
Jackson M. Day (SEC Observer)

Others at Meeting Table:
G. Michael Crooch, FASB Board Member
John M. Foster, FASB Board Member
Robert H. Herz, FASB Board Member
Gary S. Schieneman, FASB Board Member
Katherine A. Schipper, FASB Board Member
Edward W. Trott, FASB Board Member
John K. Wulff, FASB Board Member
Doug Alkema, SEC Professional Accounting Fellow
Shelly C. Luisi, SEC Associate Chief Accountant
Scott A. Taub, SEC Deputy Chief Accountant
James N. Parrott, FASB Practice Fellow
* Jules M. Cassel, FASB Senior Technical Advisor
* Halsey G. Bullen, FASB Senior Project Manager
* Brian F. Degano, FASB Practice Fellow
* Patrick G. Durbin, FASB Practice Fellow
* Vickie A. Lusniak, FASB Assistant Project Manager
* Samuel O. Lynn, FASB Practice Fellow
* Gregory S. Martin, FASB Practice Fellow
* Lisa M. Munro, FASB Practice Fellow
* Brooke E. Richards, FASB Project Research Associate
* Michael W. Tovey, FASB Practice Fellow
* Robert C. Wilkins, FASB Senior Project Manager

* For certain issues only.

ADMINISTRATIVE MATTERS

- An FASB staff representative announced the meeting dates for July and September of 2003. Along with the dates that were previously approved at the November 21, 2002 EITF meeting, the Task Force has now approved the following meeting dates for 2003:

January 23, 2003
March 20, 2003
May 15, 2003
July 31, 2003
September 16, 2003
November 13, 2003.

- The Task Force Chairman introduced Jack T. Ciesielski, owner of R.G. Associates, Inc. and publisher of *The Analyst's Accounting Observer,* as a member of the Task Force representing the user constituency.

- The Task Force Chairman announced that, beginning with the January 23, 2003 meeting, the following changes to the EITF operating procedures are effective:

  - A quorum is two-thirds of voting members or their approved substitutes. Therefore, with the current twelve-voting-member composition of the Task Force, a quorum is eight voting members (including approved substitutes).
  - A consensus of the Task Force requires that no more than one-third of the voting members or approved substitutes present at the meeting object to a proposed position on an Issue.
  - EITF consensuses are subject to ratification by the FASB at a public Board meeting held prior to the distribution of the final EITF minutes. A consensus is not considered GAAP until ratified by the FASB.

- The Task Force discussed, but was unable to finalize, certain potential revisions to the scope language of paragraph 4(a) of EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." The purpose of such revisions would be to clarify that the provisions of that Issue do not override higher-level authoritative literature. The Task Force directed the FASB staff to further develop such revisions for discussion at its next meeting and to specifically consider the interaction of this Issue with AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*.

- The Task Force discussed the report on the EITF Agenda Committee meeting. The following decisions were made by the Agenda Committee:

a. Accounting for the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities. The Agenda Committee agreed to add this Issue to the EITF agenda for discussion at the January 23, 2003 EITF meeting. Refer to discussion of EITF Issue No. 03-2, "Accounting for the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities," elsewhere in these minutes.

b. Application of Statement 133 Implementation Issue No. C11, *Scope Exceptions: Interpretation of Clearly and Closely Related in Contracts That Qualify for the Normal Purchases and Normal Sales Exception.* The Agenda Committee agreed not to add this issue to the EITF agenda. At the January 23, 2003 meeting, the Task Force recommended that the Board reconsider its decision in Implementation Issue C11.

c. Accounting for Claims-Made Insurance Policies by the Insured Entity. The Agenda Committee agreed to add this issue to the EITF agenda.

d. Applicability of FASB Statement No. 143, *Accounting for Asset Retirement Obligations,* to a Legal Obligation to Perform Asset Retirement Activities That Are Contingent on a Future Event. The Agenda Committee agreed not to add this issue to the EITF agenda and requested that the FASB staff work with the Board to provide clarifying guidance and to determine the most appropriate manner in which to communicate that guidance.

e. Determining Participating Securities and Allocation of Undistributed Earnings to Participating Securities under FASB Statement No. 128, *Earnings per Share*. The Agenda Committee agreed not to add this Issue to the EITF agenda at this time and directed the FASB staff to further explore the implications of this issue in practice and to provide an update to the Agenda Committee at its next meeting.

- An FASB staff representative announced that the FASB had decided, at its January 22, 2003 Board meeting, to address the issues in EITF Issue No. 02-12, "Permitted Activities of a Qualifying Special Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*," as part of a Board project on the interpretation of Statement 140. As a result, no further EITF discussion of Issue 02-12 is expected.

- The following comment letters were reported as received (previously distributed to all Task Force members):

a. EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities" (1 comment letter).[1]

[1] Issue not on the agenda for the January 23, 2003 meeting.

b. EITF Issue No. 02-9, "Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold" (1 comment letter).[2]

c. EITF Issue No. 02-12, "Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*" (2 comment letters).[3]

d. EITF Issue No. 03-2, "Accounting for the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities" (1 comment letter).[4]

- An FASB staff representative reported on the accounting for a modified coinsurance arrangement (also referred to as a modco arrangement). A modco arrangement is a reinsurance arrangement in which funds are withheld by the ceding insurer, thereby causing the reinsurer to recognize a receivable from the ceding insurer as well as a liability representing reserves for the insurance coverage assumed under the modco arrangement. The terms of the reinsurer's receivable provide for the future payment of principal plus a rate of return that is generally based on a specified proportion of the ceding company's return on either its general account assets or a specified block of those assets (such as a specific portfolio of the ceding company's investment securities). That portfolio is typically composed of fixed-rate debt securities. At the December 2002 AICPA Conference on Current SEC Developments, the SEC staff indicated its view that the reinsurer's receivable from the ceding company contains an embedded derivative that must be accounted for separately under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The position of the SEC staff expressed at that conference is not inconsistent with the view of the FASB staff on this issue; however, the FASB staff has not had any specific discussion of this issue with the Board.

The FASB staff plans to address this issue by combining it with a portion of the tentative guidance in Statement 133 Implementation Issue No. B36, "Bifurcation of Embedded Credit Derivatives." The FASB staff plans to expose the tentative guidance on the FASB website for the customary 35-day comment period. The tentative guidance will also address the proposed effective date and transition provisions. Statement 133 Implementation Issue No. K5, "Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues," indicates that new implementation guidance on embedded derivatives should generally be applied prospectively, for all existing contracts and future transactions, as of the effective date, without any restatement of prior years' financial statements. However, the Board can direct the staff to specify different transition guidance on the accounting for embedded derivatives if the circumstances for that issue so warrant. Implementation Issue K5 further notes that the effective date for each new Board-cleared issue would typically be the first day of each entity's first fiscal quarter following the date that the new guidance is posted on the FASB website.

[2] Discussion of comment letter occurred during the discussion of the related Issue.
[3] Issue not on the agenda for the January 23, 2003 meeting.
[4] Discussion of comment letter occurred during the discussion of the related Issue.

- The Task Force held a closed administrative session to discuss EITF operating procedures. The final rules of procedure for the EITF will be made public at a future date.

DISCUSSION OF AGENDA TECHNICAL ISSUES

Issue No. 01-8

Title: Determining Whether an Arrangement Contains a Lease

Dates Discussed: January 23–24, 2002; June 19–20, 2002; September 11-12, 2002; January 23, 2003

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

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

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

FASB Statement No. 98, *Accounting for Leases*

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

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

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

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

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

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

International Accounting Standards No. 17, *Leases*

Introduction

1. Prior to its rescission, EITF Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities,"[1] required that when the trading criteria in the consensus are met, energy contracts (including energy-related contracts such as capacity contracts, requirements contracts, and transportation contracts) should be accounted for at fair value. Paragraph 5 of that Issue stated, however, that "in certain circumstances, transportation and other energy-related contracts may represent lease transactions that should be accounted for in accordance with Statement 13 and, therefore, are not within the scope of this Issue," and went

[1] At its October 25, 2002 meeting, the Task Force reached a consensus on EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," to rescind Issue 98-10 and the related interpretive guidance of EITF Issue No. 00-17, "Measuring the Fair Value of Energy-Related Contracts in Applying Issue 98-10," and *EITF Abstracts*, Topic No. D-105, "Accounting in Consolidation for Energy Trading Contracts between Affiliated Entities When the Activities of One but Not Both Affiliates Are within the Scope of Issue No. 98-10." However, the scope of this Issue was expanded to include all arrangements, not just energy trading contracts, because of the diversity in practice in determining whether or not an arrangement contains a lease.

on to state that "the determination of whether a transportation contract or some other type of energy-related contract is a lease is a judgmental decision based on the substance of each contract."

2. In connection with the discussion of EITF Issue No. 00-17, "Measuring the Fair Value of Energy-Related Contracts in Applying Issue 98-10,"[2] the Task Force reiterated the observation that in certain circumstances, transportation and other energy-related contracts may represent lease transactions that should be accounted for in accordance with Statement 13. At the July 19-20, 2000 meeting, the Task Force agreed to add to the EITF agenda a separate issue to provide guidance for use in determining whether an energy-related contract should be considered a lease subject to the requirements of Statement 13. At the September 20, 2001 meeting, the Task Force agreed to form a working group to address this Issue and subsequently agreed to expand the Issue to address all arrangements, not just those involving energy trading contracts.

Issue

3. The issue is how to determine whether an arrangement contains a lease that is within the scope of Statement 13.

Prior EITF Discussion

4. At the January 23–24, 2002 meeting, the FASB staff reported on the November 5, 2001 and December 17, 2001 meetings of the Working Group. The Working Group agreed that the evaluation of whether an arrangement conveys the right to use property, plant, or equipment should be based on the substance of an arrangement and that the property that is the subject of a lease must be specified (explicitly or implicitly) either at inception of the arrangement or at the beginning of the lease term. The Working Group generally agreed that when property, plant, or equipment is explicitly identified and the benefits of the property, plant, or equipment are conveyed based on the passage of time, the arrangement is likely a lease. The difficulty in determining whether an arrangement is a lease arises when the property, plant, or equipment is not explicitly identified and/or the benefits of property, plant, or equipment are conveyed based on the output of the property, plant, or equipment.

5. The Working Group discussed certain characteristics that must be present in an arrangement in order for the arrangement to be a lease. The FASB staff noted that the Working Group did not complete that discussion, but tentatively agreed that an agreement conveys the *right to use* property, plant, or equipment if:

a. The property, plant, or equipment is specified either explicitly or implicitly, and

b. The arrangement conveys the right to control the use of the property, plant, or equipment. The right to control the use of the property, plant, or equipment is conveyed if the purchaser has the ability to either:

   (1) Operate the property, plant, or equipment or direct others to operate the property, plant, or equipment (for example, the ability to fire and replace the asset's operator

[2] Refer to footnote 1.

while obtaining the output of the asset or the approval of significant operating policies and procedures with respect to operating the asset), or

(2) Control access to the property, plant, or equipment.

The right to control the use of the property, plant, or equipment is not conveyed if that property, plant, or equipment may be used concurrently (at the discretion of the seller or another third party) to provide services to unrelated entities. The right to control all or a significant portion of the output of the property, plant, or equipment is indicative of the right to control the use of the asset but that, in and of itself, is not determinative that that right has been conveyed to the purchaser by the seller.

6. The FASB staff noted that the Working Group's discussions to date have focused on how to determine whether an arrangement conveys the right to control the use of specified property, plant, or equipment when the purchaser receives some or all of the output from the property, plant, or equipment. The Working Group expects to further consider that issue as well as the issue of how to determine whether property, plant, or equipment has been *implicitly* specified in an arrangement and whether a lease must convey some of the benefits and risks incident to ownership. The Task Force expressed support for the general direction of the Working Group's tentative model and encouraged further development of that model and examples to illustrate it.

7. At the June 19–20, 2002 meeting, the Task Force discussed the Working Group recommendations for this Issue. Based on those recommendations, the Task Force reached a tentative conclusion that:

> The evaluation of whether an arrangement is a lease within the scope of Statement 13 should be based on the substance of the arrangement. Paragraph 1 of Statement 13 defines a lease as:
>
> > . . . an agreement conveying the *right to use* property, plant, or equipment (land and/or depreciable assets) usually *for a stated period of time*. It includes agreements that, although not nominally identified as leases, meet the above definition, such as a "heat supply contract" for nuclear fuel.[1] This definition does not include agreements that are contracts for services that do not transfer the right to use property, plant, or equipment from one contracting party to the other. On the other hand, agreements that do transfer the right to use property, plant, or equipment meet the definition of a lease for purposes of this Statement even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets. [Emphasis added.]
> >
> > [1]Heat supply (also called "burn up") contracts usually provide for payments by the user-lessee based upon nuclear fuel utilization in the period plus a charge for the unrecovered

> cost base. The residual value usually accrues to the lessee, and the lessor furnishes no service other than the financing.[3]

Property, plant, or equipment

Property, plant, or equipment, as used in Statement 13, includes only land and/or depreciable assets. Therefore, inventory (including equipment parts inventory) and minerals, precious metals, or other natural resources cannot be the subject of a lease because those assets are not depreciable. Additionally, intangibles (for example, motion picture film licensing rights or workforce) and rights to minerals, precious metals, or other natural resources are not depreciable assets (they are amortized or depleted) so they may not be the subject of a lease.[4]

Although specific property, plant, or equipment may be explicitly identified in an arrangement, it is not the subject of a lease if fulfillment of the arrangement is not dependent on the use of the specified property, plant, or equipment. For example, if the owner/seller is obligated to deliver a specified quantity of goods or services and has the right and ability to provide those goods or services using other property, plant, or equipment not specified in the arrangement,[5] then fulfillment of the arrangement is not dependent on the specified property, plant, or equipment and the arrangement is not a lease. The owner/seller's obligation and ability to substitute other property, plant, or equipment pursuant to a warranty obligation[6] do not preclude lease treatment.

Property, plant, or equipment has been implicitly specified if, for example, the seller owns or leases only one asset with which to fulfill the obligation (and it is not economically feasible or practicable for the owner/seller to perform its obligation through the use of alternative property, plant, or equipment).

Right to use property, plant, or equipment

An arrangement conveys the *right to use* property, plant, or equipment if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying property, plant, or equipment. The right to control the use of the underlying property, plant, or equipment is conveyed if the purchaser has the ability to do either of the following:

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[3] Paragraph 64 of Statement 13 also notes that "the Board's conclusion that nuclear fuel leases meet the definition of a lease as expressed in paragraph 1 is based on the fact that under present generally accepted accounting principles a nuclear fuel installation constitutes a depreciable asset. Thus, a nuclear fuel lease conveys the right to use a depreciable asset…."

[4] Paragraph 1 of Statement 13 states that "this Statement does not apply to lease agreements concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and timber. Nor does it apply to licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights."

[5] Other property, plant, or equipment not specified in the arrangement may include property, plant, or equipment owned or controlled by the owner/seller or it may include a third party's property, plant, or equipment (for example, when the owner/seller purchases goods or services in the spot market to fulfill its obligation under the arrangement).

[6] For example, in order to substitute the same or similar property, plant, or equipment when the specified property, plant, or equipment is not operating properly.

a. Operate the property, plant, or equipment or direct others to operate the property, plant, or equipment. For example, the purchaser has the ability to do *any* of the following:
   (1) To fire and replace the asset's operator while obtaining the output of the asset
   (2) To approve significant operating policies and procedures with respect to operating the asset
   (3) To specify significant operating policies and procedures in the arrangement with the owner/seller having no ability to change such policies and procedures.[7]
b. Control access to the underlying property, plant, or equipment. For example, when *any* of the following conditions exist:
   (1) The purchaser has use of property, plant, or equipment that is an integral part of the purchaser's facilities (and the purchaser has not provided the owner/seller with an easement granting free access to and from the property, plant, or equipment)
   (2) The owner/seller is not able to use the property, plant, or equipment to provide goods or services to others (or for itself) without the purchaser's consent (even if the purchaser is not using the property, plant, or equipment)
   (3) The property, plant, or equipment may not be used concurrently (at the discretion of the owner/seller or another third party) to provide significant services to entities unrelated to the purchaser.

If the indicators of the purchaser's right to control the use of property, plant, or equipment (as indicated in the previous paragraph) are not present in the arrangement, then *any* of the following factors create a presumption that the purchaser in an arrangement has obtained the *right to use* the underlying property, plant, or equipment:

a. The purchaser has contracted to take substantially all of the output expected to be produced by the property, plant, or equipment for a period of time or stated output (the period need not be substantially all of the economic life of the property, plant, or equipment), or the purchaser has the right of first refusal to take any output in excess of the amount specified in the arrangement or has the right to restrict the sale of output by the owner/seller to others, such that the purchaser has the right to take substantially all of the output expected to be produced by the property, plant, or equipment for a period of time or stated output.
b. The purchaser guarantees the future value of the underlying property, plant, or equipment (including, for example, a guarantee of all or a portion of any debt or equity financing).
c. The purchaser has a bargain purchase option to acquire the underlying property, plant, or equipment.

The presumption, described in the previous paragraph, that the purchaser has obtained the right to use the underlying property, plant, or equipment is overcome, and the arrangement should be accounted for as a service arrangement, if *both* of the following criteria are met:

[7] A requirement to follow "prudent operating practices" (or other similar requirements) generally does not convey the right to control the underlying property, plant, or equipment.

a. The pricing under the arrangement is not designed to provide the owner/seller with a recovery of substantially all of its costs to own or operate the property, plant, or equipment. For example, arrangements in which the price that the purchaser will pay for the output is either fixed per unit of output or indexed to market prices of the output would indicate that the arrangement is not designed to provide the owner/seller a recovery of substantially all of its costs to own or operate the property, plant, or equipment.
b. The arrangement requires the owner/seller to pay substantive damages, based on the then current market prices, to the purchaser if it fails to deliver,[8] and the owner/seller is a substantive entity with the financial ability to fulfill its obligations under the arrangement.

Stated period of time

Although a lease normally provides for the use of property, plant, or equipment for a specified period of time, an arrangement providing for a specified measure of use (for example, a number of units produced) is within the scope of Statement 13. The arrangement must include a "Lease Term" as defined in paragraph 5(f) of Statement 13 (as amended by paragraph 22 of Statement 98). This does not preclude the measure of time being specified as being contingent on a future event.[9]

8. The Task Force requested that the Working Group provide the basis for its recommendations for inclusion in the abstract of this Issue. Additionally, the Task Force asked the Working Group to consider whether the fact that any party, other than the purchaser of output, controls the use of the property, plant, or equipment should be determinative that the arrangement is not a lease within the scope of Statement 13.

9. The Task Force discussed whether an undivided interest in property, plant, or equipment could be the subject of a lease. That is, whether an undivided interest holder would have the ability to control the use of a portion of specified property, plant, or equipment[10] (on either a pro rata or non–pro rata basis) and, if so, whether such a right can be conveyed (leased) by the undivided interest holder. The Task Force reached a tentative conclusion that an undivided interest in property, plant, or equipment may be the subject of a lease if the criteria in paragraph 7, above, are met. The SEC Observer requested the Task Force to consider whether a lease of an undivided interest can ever be a capital, sales-type, or direct financing lease within the scope of Statement 13. The Task Force requested that the Working Group address that issue.

[8] In other words, the owner/seller is obligated to pay market-based liquidating damages over the term of the arrangement to compensate the purchaser for actual losses incurred as a result of the buyer's having to locate an alternative supply of the item required to be delivered from the specified property, plant, or equipment.
[9] For example, a lease of school buses could expire "at the end of the 2004–2005 school year." The fact that the school district had not yet set the calendar for the last day of school in 2005 should not lead to a conclusion that the contract is a service arrangement.
[10] The *specified property, plant, or equipment* may be the undivided interest in property, plant or equipment.

10. At the September 11–12, 2002 meeting, the Task Force withdrew its prior tentative conclusion that an undivided interest in property, plant, or equipment may be the subject of a lease. Some Task Force members suggested that a portion of property, plant, or equipment (including an undivided interest) may be the subject of a lease *only* if that portion is a separate functional unit (for example, one floor of an office building). The Task Force requested that the Working Group prepare a draft abstract for approval by the Task Force at its next meeting that addresses the following points:

a. The meaning of "separate functional unit"
b. Whether the fact that any party, other than the purchaser of output, controls the use of the property, plant, or equipment should be determinative that the arrangement is not a lease within the scope of Statement 13
c. Issues raised in the comment letters received to date
d. Transition issues
e. Examples applying the consensus.

Current EITF Discussion

11. At the January 23, 2003 meeting, the Task Force discussed a revised Working Group recommendation that was based on the tentative conclusion reached at the June 19-20, 2002 meeting (refer to paragraph 7, above). The Task Force reached a tentative conclusion that the following model should be used in determining whether an arrangement contains a lease. The model is marked to reflect changes from the June 2002 tentative conclusion (additions are underscored and deletions are struck through):

> The evaluation of whether an arrangement ~~is~~<u>contains</u> a lease within the scope of Statement 13 should be based on the substance of the arrangement. Paragraph 1 of Statement 13 defines a lease as:
>
> > . . . an agreement conveying the *right to use* property, plant, or equipment (land and/or depreciable assets) usually *for a stated period of time*. It includes agreements that, although not nominally identified as leases, meet the above definition, such as a "heat supply contract" for nuclear fuel.[1] This definition does not include agreements that are contracts for services that do not transfer the right to use property, plant, or equipment from one contracting party to the other. On the other hand, agreements that do transfer the right to use property, plant, or equipment meet the definition of a lease for purposes of this Statement even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets. [Emphasis added.]
> >
> > [1]Heat supply (also called "burn up") contracts usually provide for payments by the user-lessee based upon nuclear fuel utilization in the period plus a charge for the unrecovered cost base. The residual value usually accrues to the lessee, and the lessor furnishes no service other than the financing.[3]

Property, plant, or equipment

Property, plant, or equipment, as used in Statement 13, includes only land and/or depreciable assets. Therefore, inventory (including equipment parts inventory) and minerals, precious metals, or other natural resources cannot be the subject of a lease for accounting purposes because those assets are not depreciable. Additionally, intangibles (for example, motion picture film licensing rights or workforce) and rights to minerals, precious metals, or other natural resources are not depreciable assets (they are amortized or depleted) so they may not be the subject of a lease.[4]

Although specific property, plant, or equipment may be explicitly identified in an arrangement, it is not the subject of a lease if fulfillment of the arrangement is not dependent on the use of the specified property, plant, or equipment. For example, if the owner/seller is obligated to deliver a specified quantity of goods or services and has the right and ability to provide those goods or services using other property, plant, or equipment not specified in the arrangement,[5] then fulfillment of the arrangement is not dependent on the specified property, plant, or equipment and the arrangement ~~is~~does not contain a lease. The owner/seller's obligation and ability to substitute other property, plant, or equipment pursuant to a warranty obligation[6] do not preclude lease treatment. In addition, an owner/seller's obligation (contingent or otherwise) or ability to substitute other property, plant, or equipment for any reason on or after a specified date does not preclude lease treatment prior to the date of substitution.

Property, plant, or equipment has been implicitly specified if, for example, the seller owns or leases only one asset with which to fulfill the obligation ~~(~~and it is not economically feasible or practicable for the owner/seller to perform its obligation through the use of alternative property, plant, or equipment~~)~~.

Right to use property, plant, or equipment

An arrangement conveys the *right to use* property, plant, or equipment if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying property, plant, or equipment. The right to control the use of the underlying property, plant, or equipment is conveyed if the purchaser has the ability or right to do any one~~either~~ of the following:

a. Operate the property, plant, or equipment or direct others to operate the property, plant, or equipment in a manner it determines while obtaining or controlling the output or other utility of the property, plant, or equipment,~~.~~ ~~For example, the purchaser has the ability to do *any* of the following:~~
   ~~(1) To fire and replace the asset's operator while obtaining the output of the asset~~
   ~~(2) To approve significant operating policies and procedures with respect to operating the asset~~

~~(3) To specify significant operating policies and procedures in the arrangement with the owner/seller having no ability to change such policies and procedures.~~[7]

b. Control physical access to the underlying property, plant, or equipment or~~.~~ ~~For example, when *any* of the following conditions exist:~~

~~(1) The purchaser has use of property, plant, or equipment that is an integral part of the purchaser's facilities (and the purchaser has not provided the owner/seller with an easement granting free access to and from the property, plant, or equipment)~~

~~(2) The owner/seller is not able to use the property, plant, or equipment to provide goods or services to others (or for itself) without the purchaser's consent (even if the purchaser is not using the property, plant, or equipment)~~

~~(3) The property, plant, or equipment may not be used concurrently (at the discretion of the owner/seller or another third party) to provide significant services to entities unrelated to the purchaser.~~

~~If the indicators of the purchaser's right to control the use of property, plant, or equipment (as indicated in the previous paragraph) are not present in the arrangement, then *any* of the following factors create a presumption that the purchaser in an arrangement has obtained the *right to use* the underlying property, plant, or equipment:~~

~~a. The purchaser has contracted to take substantially all of the output expected to be produced by the property, plant, or equipment for a period of time or stated output (the period need not be substantially all of the economic life of the property, plant, or equipment), or the purchaser has the right of first refusal to take any output in excess of the amount specified in the arrangement or has the right to restrict the sale of output by the owner/seller to others, such that the purchaser has the right to take substantially all of the output expected to be produced by the property, plant, or equipment for a period of time or stated output.~~

~~b. The purchaser guarantees the future value of the underlying property, plant, or equipment (including, for example, a guarantee of all or a portion of any debt or equity financing).~~

~~c. The purchaser has a bargain purchase option to acquire the underlying property, plant, or equipment.~~

~~The presumption, described in the previous paragraph, that the purchaser has obtained the right to use the underlying property, plant, or equipment is overcome, and the arrangement should be accounted for as a service arrangement, if both of the following criteria are met:~~

c. Take substantially all of the output or other utility expected to be produced or generated by the property, plant, or equipment for the term of the arrangement, unless both of the following conditions are met:

~~a~~i. The ~~pricing under the arrangement is not designed to provide the owner/seller with a recovery of substantially all of its costs to own or operate the property, plant, or equipment. For example, arrangements in which the~~ price that the purchaser will pay for the output is either fixed per unit of output or indexed to market prices of the output~~would indicate that the arrangement is not designed to provide the owner/seller a recovery of substantially all of its costs to own or operate the property, plant, or equipment.~~

~~b~~ii. The arrangement requires the owner/seller to pay substantive damages, based on the then current market prices, to the purchaser if it fails to deliver,[8] and the owner/seller is a substantive entity with the financial ability to fulfill its obligations under the arrangement.

~~*Stated period of time*~~

~~Although a lease normally provides for the use of property, plant, or equipment for a specified period of time, an arrangement providing for a specified measure of use (for example, a number of units produced) is within the scope of Statement 13. The arrangement must include a "Lease Term" as defined in paragraph 5(f) of Statement 13 (as amended by paragraph 22 of Statement 98). This does not preclude the measure of time being specified as being contingent on a future event.~~[9]

Timing of assessment

The assessment of whether an arrangement contains a lease should be made at inception of the arrangement based on all of the facts and circumstances. A reassessment of whether the arrangement contains a lease after inception of the arrangement should only be made if the arrangement is significantly modified.[9] Changes in circumstances (for example, changes in the productivity of the property, plant, or equipment when the purchaser's right to output is capped) do not modify the arrangement.

[3] Paragraph 64 of Statement 13 also notes that "the Board's conclusion that nuclear fuel leases meet the definition of a lease as expressed in paragraph 1 is based on the fact that under present generally accepted accounting principles a nuclear fuel installation constitutes a depreciable asset. Thus, a nuclear fuel lease conveys the right to use a depreciable asset…."

[4] Paragraph 1 of Statement 13 states that "this Statement does not apply to lease agreements concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and timber. Nor does it apply to licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights."

[5] Other property, plant, or equipment not specified in the arrangement may include property, plant, or equipment owned or controlled by the owner/seller, or it may include a third party's property,

plant, or equipment (for example, when the owner/seller purchases goods or services in the spot market to fulfill its obligation under the arrangement).

[6] For example, in order to substitute the same or similar property, plant, or equipment when the specified property, plant, or equipment is not operating properly.

[7] The purchaser's ability to operate the property, plant, or equipment may be evidenced by (but is not limited to) the purchaser's ability to hire, fire, or replace the property's operator or the purchaser's ability to specify significant operating policies and procedures in the arrangement with the owner/seller having no ability to change such policies and procedures. A requirement to follow "prudent operating practices" (or other similar requirements) generally does not convey the right to control the underlying property, plant, or equipment. Similarly, a contractual requirement designed to enable the purchaser to monitor or ensure the seller's compliance with performance, safety, pollution control, or other general standards generally does not establish control over the underlying property, plant, or equipment.

[8] In other words, the owner/seller is obligated to pay market-based liquidating damages over the term of the arrangement to compensate the purchaser for actual losses incurred as a result of the purchaser~~buyer~~'s having to locate an alternative supply of the item required to be delivered from the specified property, plant, or equipment. If the price per unit is based on market prices, there may be no requirement for damages. However, this requirement would still be considered to have been met.

[9] A significant modification to an arrangement is one in which the determination that an arrangement contains a lease (or does not contain a lease) would change from the previous determination using the modified arrangement and the circumstances that existed at inception. ~~For example, a lease of school buses could expire "at the end of the 2004–2005 school year." The fact that the school district had not yet set the calendar for the last day of school in 2005 should not lead to a conclusion that the contract is a service arrangement.~~

12. The Task Force instructed the Working Group to draft an abstract for approval by the Task Force at its March 20, 2003 meeting. The Task Force requested that the Working Group address the following points:

a. The interaction, if any, between Statement 13 and Statement 133 and what differentiates each Statement when applied to arrangements contemplated by this Issue
b. How the "substantially all" portion of the proposed recommendation (in paragraph 11, above) is applied.

The Task Force also requested that the Working Group provide additional examples applying the proposed recommendation, propose guidance on transition, and provide a basis for its recommendations to be included in the abstract.

Status

13. Further discussion is expected at a future meeting.

Issue No. 02-2

Title: When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes

Dates Discussed: January 23–24, 2002; January 23, 2003

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

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

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

Proposed FASB Statement, *Accounting for Certain Instruments with Characteristics of Liabilities and Equity*

Statement 133 Implementation Issue No. F6, "Concurrent Offsetting Matching Swaps and Use of One as a Hedging Instrument"

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

Statement 133 Implementation Issue No. K2, "Are Transferable Options Freestanding or Embedded?"

Statement 133 Implementation Issue No. K3, "Determination of Whether Combinations of Options with the Same Terms Must Be Viewed as Separate Option Contracts or as a Single Forward Contract"

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

Introduction

1. Companies may, for various reasons, contemporaneously enter into multiple contracts that individually meet the definition of a financial instrument in paragraph 540 of Statement 133. The financial reporting impact of recording those contracts separately may be different from the financial reporting impact of recording those contracts on a combined basis. A working group has been formed to address this Issue.

Issue

2. The issue is how to determine when certain contracts that meet the definition of a financial instrument should be combined for accounting purposes.

Prior EITF Discussion

3. At the January 23–24, 2002 EITF meeting, the FASB staff reported on the initial meeting of the Working Group. The Working Group preliminarily agreed that two or more financial instruments should be required to be combined for accounting purposes if *all* of the following four criteria are met:

- The transactions or contracts are with the same counterparties (or are structured through an intermediary).
- The transactions or contracts are entered into in contemplation of one another.
- The separate transactions or contracts share at least one underlying, and changes in that underlying (holding the other underlyings constant) result in at least one substantially offsetting change in fair value for those transactions or contracts.
- The structure of the arrangement (separate contracts) does not serve a substantive business purpose that is fundamentally unrelated to the accounting (that is, the business purpose is not directly or indirectly based on the accounting result) and that could not have been accomplished in a single contract or transaction.

The Working Group also observed that it does not appear possible (or desirable) to remove all judgment from the decision to combine multiple financial instruments for accounting purposes.

4. Some Working Group members expressed concern that the Working Group's approach would require an extensive review of contracts (and documentation of that review) to be performed that might not be operational in certain circumstances. One example of that concern might be the central treasury function of a financial institution for which it would not be uncommon to have multiple trades with the same counterparties on any given day (for substantive business reasons). Those Working Group members want to ensure any model developed is practical to implement. A majority of the Working Group did not disagree with that sentiment but thought the proposed guidance would limit the requirement to combine contracts to situations in which combining would change the accounting outcome. They believe that the operationality concern can be addressed by better explaining that point as the model is further refined. At a future meeting, the Working Group plans to further refine its model, develop additional examples illustrating the model's application, and test the model's scope to ensure that it is consistent with existing GAAP (in particular, the requirements of Statements 133 and 140).

5. The FASB staff explained that the Board is planning to consider whether combining certain financial instruments is appropriate in its redeliberations of its liabilities and equity project. The Task Force expressed support for the general direction the Working Group is taking and encouraged further development of the Working Group's model. The Task Force directed the FASB staff to keep the Working Group and the Task Force apprised of the Board's progress on its liabilities and equity project and the potential implications for this Issue of the Board's decisions.

Current EITF Discussion

6. At the January 23, 2003 meeting, the FASB staff informed the Task Force of the Board's intent to issue FASB Statement, *Accounting for Certain Financial Instruments with Characteristics of Liabilities and Equity*, in February 2003. The FASB staff stated that that Statement results from Phase One of the liabilities and equity project and, as currently drafted, requires liability classification for certain financial instruments that were previously classified as equity. Instruments within the scope of that Statement are classified as liabilities and measured accordingly and are specifically precluded from being combined with other freestanding financial instruments. Consequently, financial instruments included in the scope of that Statement would no longer be subject to a combining model to be developed in this Issue.

Additionally, the FASB staff stated that Phase Two of the liabilities and equity project is expected to start immediately following the issuance of the final Statement for Phase One and that a final Statement for Phase Two is projected to be issued by the end of 2003. The Task Force discussed whether it would be appropriate to continue its discussions of this Issue in light of the Board's concurrent activities in developing classification and separation guidance for instruments within the scope of the liabilities and equity project. As a result of those discussions, the Task Force directed the FASB staff (and the Working Group) to continue to work on this Issue only for financial instruments that are outside the scope of the liabilities and equity project. The scope of the Board's project, as communicated in the October 2000 Exposure Draft on liabilities and equity, includes financial instruments with characteristics of liabilities or equity or both.

Status

7. Further discussion is expected at a future meeting.

Issue No. 02-9

Title: Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold

Dates Discussed: September 11–12, 2002; November 21, 2002; January 23, 2003

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

FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*

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

FASB Statement No. 122, Accounting for Mortgage Servicing Rights

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

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

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

FASB Statement No. 141, *Business Combinations*

FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*

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

FASB Special Report, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities: Questions and Answers*

FASB Special Report, *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities: Questions and Answers*

APB Opinion No. 16, *Business Combinations*

APB Opinion No. 20, *Accounting Changes*

AICPA Audit and Accounting Guide, *Banks and Savings Institutions*

SEC Staff Accounting Bulletin No. 61, *Allowance Adjustments*

International Accounting Standard No. 39, *Financial Instruments: Recognition and Measurement*

Introduction

1. A key concept in Statement 140 is that a transferred asset that has been accounted for as sold is accounted for as "re-purchased" if the basis for that sale accounting becomes invalid

subsequent to the initial accounting for the transaction. That concept is articulated in paragraph 55 of Statement 140, which states:

> A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor's regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 9 are no longer met. Such a change, unless it arises solely from either the initial application of this Statement or a change in market prices (for example, an increase in price that moves into-the-money a freestanding call that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), is accounted for in the same manner as a purchase of the assets from the former transferee(s) in exchange for liabilities assumed (paragraph 11). After that change, the transferor recognizes in its financial statements those assets together with liabilities to the former transferee(s) or BIHs in those assets (paragraph 38). The transferor initially measures those assets and liabilities at fair value on the date of the change, as if the transferor purchased the assets and assumed the liabilities on that date. The former transferee would derecognize the assets on that date, as if it had sold the assets in exchange for a receivable from the transferor.

Two circumstances that have raised questions about the application of paragraph 55 occur when the provisions of paragraph 55 are triggered because (a) a qualifying special-purpose entity (SPE) becomes nonqualifying and (b) the transferor holds a contingent right such as a contingent call option on the transferred financial assets (for example, a removal of accounts provision or "ROAP") and the contingency has been met.

2. A qualifying SPE may become nonqualifying or "tainted" for several reasons, including a decision by the outside beneficial interest holders to grant the SPE decision-making powers that are prohibited for qualifying SPEs. Under the requirements of paragraph 55, a qualifying SPE that becomes tainted will generally result in the "re-purchase" by the transferor of *all* assets transferred to and held by the SPE.

3. Under Statement 140, rights held by the transferor (typically in the form of purchased options or forward purchase contracts) only preclude sale accounting under paragraph 9(c)(2) if they provide the transferor with the *unilateral* right to cause the holder to return *specific* transferred assets. One class of contingent rights (including certain ROAPs[1]) does not preclude sale accounting because it does not include unilateral rights. The most common type of ROAP is a default ROAP, which gives the holder the right but not the obligation to purchase (call) a loan that is in default (the meaning of default typically is specifically defined in each transaction). Such rights are common in credit card securitizations and in securitizations sponsored by the Government National Mortgage Association (GNMA)[2] and other governmental or quasi-governmental agencies. Once the contingency is met (in this case, when a given loan goes into

[1] Although this Issue uses ROAPs as an example, the guidance is not limited to ROAPs. Contingent rights can arise in many other fact patterns. Refer to Question 49 of the Statement 140 Special Report for more information.
[2] GNMA ROAPs are actually held by the servicer of the transferred loans. However, when the servicer is the transferor, the provisions of Statement 140 apply to the ROAP.

default), the call option on that asset (loan) is no longer contingent. At that point, the transfer fails the criterion in paragraph 9(c)(2) of Statement 140 because the transferor has the unilateral right to purchase a specific transferred asset. Under the requirements of paragraph 55 of Statement 140, when a contingency related to a transferor's contingent right has been met, the transferor generally must account for the "re-purchase" of *a specific subset* of the assets transferred to and held by the qualifying SPE. The transferor must do so *regardless of whether it intends to exercise its call option*.

Issues

4. The issues are:

Issue 1—How the transferor should account for retained beneficial interests when the underlying assets are re-recognized under the provisions of paragraph 55 of Statement 140 because the transferor's contingent right (for example, a "ROAP" or other contingent call option on the transferred financial assets) becomes exercisable, and, in particular, how much of any gain or loss[3] should the transferor recognize when paragraph 55 of Statement 140 is applied.

Issue 2—How assets of an SPE that was formerly considered qualifying should be accounted for when the entire SPE becomes non-qualifying under the provisions of paragraph 55 of Statement 140, including whether the transferor should recognize a gain or loss when paragraph 55 of Statement 140 is applied.

Issue 3—Whether under any circumstances a loan loss allowance should initially be recorded for loans that do not meet the definition of a *security* when they are re-recognized under the provisions of paragraph 55 of Statement 140. (Formerly Issue 2.)

Issue 4—How re-recognition under paragraph 55 of assets sold affects the accounting for the related servicing asset.

Prior EITF Discussion

5. At the September 11–12, 2002 meeting, the Task Force discussed Issue 1 but was not able to reach a consensus. The Task Force asked the FASB staff to provide additional examples to show how other assets or liabilities (such as servicing) would be affected by the re-recognition of assets under paragraph 55. Also, the Task Force asked the FASB staff to clarify what the effect of re-recognition should be on the retained beneficial interest. Specifically, the Task Force asked the FASB staff to further consider whether changes in the fair value of a retained interest that result prior to re-characterization from, for example, a security to a loan should be (a) included in the new carrying amount of the loan or (b) eliminated from accumulated other comprehensive income (if previously accounted for as an available-for-sale security) or income (if previously accounted for as a trading security) when paragraph 55 is applied. The Task Force also asked the FASB staff to clarify whether a re-recognition pursuant to paragraph 55 should cause the transferor to evaluate the retained beneficial interest for impairment.

[3] Some potentially recognizable gain or loss arises from the difference between the strike price of the option (ROAP) and the fair value of the assets that had been previously transferred to the qualifying SPE. Additional potentially recognizable gain may arise if unrealized appreciation in the transferor's retained beneficial interest has been recorded in Other Comprehensive Income.

6. The Task Force reached a consensus on Issue 3 that under no circumstances should a loan loss allowance be initially recorded for loans that do not meet the definition of a *security* when they are re-recognized pursuant to paragraph 55.

7. At the November 21, 2002 meeting, the Task Force reached a consensus on Issue 1 that upon application of paragraph 55, no gain or loss should be recognized in earnings with respect to any beneficial interests retained by the transferor. A gain or loss may be recognized only with respect to the "re-purchased" third-party beneficial interests (the portion of the transferred assets that were sold) and only if a ROAP or similar contingent right held by the transferor that is not accounted for as a derivative under Statement 133 is not at-the-money, resulting in the fair value of those beneficial interests being greater or less than related obligations to the transferee. Beneficial interests should be evaluated periodically for possible impairment, including at the time paragraph 55 is applied.

8. The Task Force discussed but was not able to reach a consensus on either Issue 2 or Issue 4. The Task Force asked the FASB staff to provide additional examples that would clarify the accounting when the entire SPE is disqualified and (a) the assets being re-recognized are initially measured at fair value and the retained interests are measured at an amount other than fair value and (b) both the assets being re-recognized and the retained interests are measured at fair value. The Task Force asked that those examples include the accounting for related servicing assets.

Current EITF Discussion

9. At the January 23, 2003 meeting, the Task Force discussed Issue 2 but was unable to reach a consensus. The FASB staff believes that no gain or loss should be recognized on the re-recognition of assets due to the disqualification of a formerly qualifying SPE. Additionally, the FASB staff clarified that paragraph 55 of Statement 140 should be applied in re-recognizing the assets and recognizing the liability to the SPE before applying Interpretation 46 to the now nonqualifying SPE to determine whether it should be consolidated by the transferor or other parties that may hold variable interests in the SPE.

10. The Task Force asked the FASB staff to provide additional examples of the accounting if a portion of the SPE's assets are due from certain third parties (for example, transactions involving guarantees of the obligations under the beneficial interests). The Task Force also asked the FASB staff to research and provide additional information as to (a) whether and/or why the fair value of the assets re-recognized and the fair value of the liability to the SPE recognized by the transferor are always equal and (b) which of those amounts can be more reliably measured.

11. The Task Force reached a tentative conclusion on Issue 4 that, even though a transferor has regained control over the underlying assets, the related servicing asset should continue to be separately recognized, amortized, and evaluated for impairment under Statement 140.

Status

12. Further discussion is expected at a future meeting.

Issue No. 02-14

Title: Whether the Equity Method of Accounting Applies When an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means

Dates Discussed: September 11–12, 2002; November 21, 2002; January 23, 2003

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

FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*

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

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

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

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

FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*

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

Proposed FASB Statement, *Consolidated Financial Statements: Purpose and Policy*, dated February 23, 1999

Proposed FASB Statement, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*, dated October 27, 2000

Proposed FASB Interpretation, *Consolidation of Certain Special-Purpose Entities*, dated June 28, 2002

FASB Special Report, *Reporting Interests in Joint Ventures and Similar Arrangements*

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

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

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

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*

AICPA Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*, Exhibit I, "ADC Arrangement"

Proposed AICPA Statement of Position, *Accounting for Investors' Interests in Unconsolidated Real Estate Investments*, dated November 21, 2000

AICPA Statement on Auditing Standards No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

SEC Staff Accounting Bulletin No. 59, *Accounting for Noncurrent Marketable Equity Securities*

International Accounting Standard 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*

International Accounting Standard 28, *Accounting for Investments in Associates*

Standards Interpretations Committee 12, *Consolidation—Special Purpose Entities*

Standards Interpretations Committee 20, *Equity Accounting Method—Recognition of Losses*

Standards Interpretations Committee 33, *Consolidation and Equity Method—Potential Voting Rights and Allocation of Ownership Interests*

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, "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, "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)

[1] Although, the Interpretation states, "Many of the provisions of the Opinion would be appropriate in accounting for investments in these unincorporated entities [partnerships and unincorporated joint ventures]. . . ."

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 people believe that existing authoritative literature already addresses an investors' accounting for a number of those kinds of 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 non-common 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 issue is whether the equity method of accounting applies when an investor does not have an investment in voting common stock of an investee but exercises significant influence through other means.

Prior EITF Discussion

6. At the September 11–12, 2002 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 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 U.S. GAAP when developing its views. The Task Force also requested that the scope of the impairment issue be expanded to include equity

[2] See paragraph 17 of Opinion 18 and paragraph 4 of Interpretation 35.
[3] EITF Agenda Committee background material for May 1998.

method investments and investments subject to Statement 115 and that that issue be addressed by the Task Force as a separate EITF Issue.

Current EITF Discussion

9. At the January 23, 2003 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.

Status

12. Further discussion is expected at a future meeting.

Issue No. 02-16

Title: Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor

Dates Discussed: September 11–12, 2002; November 21, 2002; January 23, 2003

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

FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*

FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*

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

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

APB Opinion No. 29, *Accounting for Nonmonetary Transactions*

AICPA Audit and Accounting Guide, *Agricultural Producers and Agricultural Cooperatives*

International Accounting Standard 20, *Accounting for Government Grants and Disclosure of Government Assistance*

Introduction

1. EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)," addresses the accounting by a **vendor**[1] for consideration given to a **customer**, including both a **reseller** of the vendor's products and an entity that purchases the vendor's products from a reseller. That Issue provided accounting guidance on how a vendor should characterize consideration given to a customer and when to recognize and how to measure that consideration in its income statement.

2. Questions have arisen regarding how a reseller of a vendor's products should account for **cash consideration** (as that term is defined in Issue 01-9) received from a vendor.

Issues

3. The issues are:

Issue 1—The circumstances under which cash consideration received from a vendor by a reseller should be considered (a) an adjustment of the prices of the vendor's products or services and, therefore, characterized as a reduction of cost of sales when recognized in the reseller's income statement, (b) an adjustment to a cost incurred by the reseller and, therefore, characterized as a reduction of that cost when recognized in the reseller's income statement, or (c) a payment for

[1] Terms defined in Exhibit 02-16B, the glossary, are set forth in **boldface type** the first time they appear.

assets or services delivered to the vendor and, therefore, characterized as revenue when recognized in the reseller's income statement.

Issue 2—If a vendor offers a customer a rebate or refund of a specified amount of cash consideration that is payable only if the customer completes a specified cumulative level of purchases or remains a customer for a specified time period, when the customer should recognize the rebate and how the customer should measure the amount of the offer.

Issue 3—Under what circumstances up-front nonrefundable cash consideration given by a vendor to a customer should be recognized immediately in the customer's income statement rather than as a liability.

Issue 4—How to measure and when to recognize the reduction of a liability incurred upon receipt of up-front nonrefundable cash consideration in the customer's income statement.

Prior EITF Discussion

4. At the September 11–12, 2002 meeting, the Task Force discussed Issue 1 but was not asked to reach a consensus. The Task Force asked the FASB staff to expand the scope of this Issue to (a) include resellers that sell goods or services to a vendor (that is, resellers and vendors that sell goods or services to each other), (b) include end-users that receive cash consideration from a vendor, and (c) provide guidance on the recognition and measurement of cash consideration (including up-front nonrefundable cash consideration) received from a vendor.

5. The SEC Observer commented that, until further guidance is issued, resellers that provide goods or services to a vendor from which they also purchase goods or services should consider whether certain transactions between the two parties (for example, a reseller providing goods or services to a vendor with a contemporaneous agreement to purchase an equal amount of that vendor's goods or services) are subject to the guidance contained in paragraph 21 of Opinion 29.

6. The Task Force did not discuss Issue 2.

7. At the November 21, 2002 meeting, the Task Force reached a consensus on Issue 1 that cash consideration received by a customer from a vendor is presumed to be a reduction of the prices of the vendor's products or services and should, therefore, be characterized as a reduction of cost of sales when recognized in the customer's income statement. However, that presumption is overcome when the consideration is either (a) a payment for assets or services delivered to the vendor, in which case the cash consideration should be characterized as revenue (or other income, as appropriate) when recognized in the customer's income statement, or (b) a reimbursement of costs incurred by the customer to sell the vendor's products, in which case the cash consideration should be characterized as a reduction of that cost when recognized in the customer's income statement.

8. The Task Force reached a consensus that cash consideration represents a payment for assets or services delivered to the vendor, and should be characterized as revenue (or other income, as appropriate) when recognized in the customer's income statement if the vendor receives, or will receive, an identifiable benefit (goods or services) in exchange for the consideration. In order to

meet that condition the identified benefit must be sufficiently separable from the customer's purchase of the vendor's products such that the *customer* would have entered into an exchange transaction with a party other than the vendor in order to *provide* that benefit, and the customer can reasonably estimate the fair value of the benefit provided. If the amount of cash consideration paid by the vendor exceeds the estimated fair value of the benefit received, that excess amount should be characterized as a reduction of cost of sales when recognized in the customer's income statement.

9. The Task Force reached a consensus that cash consideration represents a reimbursement of costs incurred by the customer to sell the vendor's products and should be characterized as a reduction of that cost when recognized in the customer's income statement if the cash consideration represents a reimbursement of a specific, incremental, identifiable cost incurred by the customer in selling the vendor's products or services. If the amount of cash consideration paid by the vendor exceeds the cost being reimbursed, that excess amount should be characterized in the customer's income statement as a reduction of cost of sales when recognized in the customer's income statement.

10. The Task Force reached a consensus on Issue 2 that a rebate or refund of a specified amount of cash consideration that is payable pursuant to a binding arrangement only if the customer completes a specified cumulative level of purchases or remains a customer for a specified time period should be recognized as a reduction of the cost of sales based on a systematic and rational allocation of the cash consideration offered to each of the underlying transactions that results in progress by the customer toward earning the rebate or refund provided the amounts are probable and reasonably estimable. If the rebate or refund is not probable and reasonably estimable, it should be recognized as the milestones are achieved.

11. The Task Force observed that the ability to make a reasonable estimate of the amount of future cash rebates or refunds depends on many factors and circumstances that will vary from case to case. However, the Task Force reached a consensus that the following factors may impair a customer's ability to determine whether the rebate or refund is probable and reasonably estimable:

a. The rebate or refund relates to purchases that will occur over a relatively long period.
b. There is an absence of historical experience with similar products or the inability to apply such experience because of changing circumstances.
c. Significant adjustments to expected cash rebates or refunds have been necessary in the past.
d. The product is susceptible to significant external factors (for example, technological obsolescence or changes in demand).

12. The Task Force reached a consensus that changes in the estimated amount of cash rebates or refunds and retroactive changes by a vendor to a previous offer (an increase or a decrease in the rebate amount that is applied retroactively) are changes in estimate that should be recognized using a cumulative catch-up adjustment. That is, the customer would adjust the cumulative balance of its rebate recognized to the revised cumulative estimate immediately. The Task Force observed that entities should consider whether any portion of the cumulative-effect adjustment

impacts, for example, inventory, in which case only a portion of that adjustment would be reflected in the income statement.

13. The Task Force agreed to discontinue consideration of Issues 3 and 4 regarding whether up-front nonrefundable cash consideration given by a vendor to a customer results in a liability or should be recognized immediately in the customer's income statement due to the broad, general nature of related questions.

14. The examples in Exhibit 02-16A illustrate the consensuses reached in this Issue.

Transition

15. Subsequent to the November 21, 2002 meeting, the Task Force modified the transition guidance agreed to at that meeting. At that meeting, the Task Force agreed that the consensus on Issue 1 should be applied to fiscal periods beginning after December 15, 2002, with early application permitted. Additionally, the Task Force indicated that income statements for prior periods presented should be reclassified to comply with the consensus on Issue 1, unless such reclassification is impracticable. However, subsequent to that meeting, Task Force members acknowledged that the recasting of prior-period financial statements for comparative purposes might impact certain balance sheet and income statement account balances such that the net income of prior periods would be changed. Accordingly, the transition guidance in the following paragraph is provided to consider such circumstances.

16. The consensus on Issue 1 should be applied to fiscal periods beginning after December 15, 2002. Upon application of the consensus on Issue 1, income statements for prior periods presented should be reclassified to comply with that consensus, provided that the recasting of prior-period financial statements does not result in a change to net income of those prior periods. If it is impracticable to reclassify prior-period financial statements, disclosure should be made of the reasons therefor and the effect of the reclassification on the current period. Early application of the consensus on Issue 1 is permitted only if a change to previously reported net income would not occur as a result of changes to prior-period financial statements. At its January 23, 2003 meeting, the Task Force intends to further discuss transition for entities in which previously reported net income would be changed as a result of recasting prior-period financial statements for comparative purposes.

17. The consensus on Issue 2 is effective for arrangements entered into after November 21, 2002.

Current EITF Discussion

18. At the January 23, 2003 meeting, the Task Force rescinded the transition guidance provided on Issue 1 at the November 21, 2002 meeting. The Task Force concluded that the consensus on Issue 1 should be applied to new arrangements, including modifications of existing arrangements, entered into after December 31, 2002. If determinable, pro forma disclosure of the impact of the consensus on prior periods presented is encouraged. Early application of the consensus is permitted as of the beginning of periods for which financial statements have not been issued.

Status

19. No further EITF discussion is planned.

Exhibit 02-16A

EXAMPLES OF THE APPLICATION OF THE CONSENSUS

Example 1

Vendor manufactures toys that are sold by Retailer. Vendor offers a **cooperative advertising** arrangement through which Retailer receives an allowance for qualifying advertising costs of up to 2 percent of the total purchases from Vendor if certain qualitative criteria are met. Retailer must maintain documentation of advertising performed and related costs.

Evaluation: The cash consideration received for cooperative advertising, to the extent that it represents a reimbursement of specific, incremental, identifiable costs incurred by the customer to sell Vendor's products, should be characterized as a reduction of those costs when recognized in the customer's income statement, provided that the cash consideration received does not exceed such costs incurred. If the amount of cash consideration paid by Vendor exceeds the costs being reimbursed, that excess amount should be characterized as a reduction of cost of sales when recognized in Retailer's income statement.

Example 2

Retailer enters into an agreement with Vendor to perform a significant amount of market research for Vendor related to the launch of a new product. Vendor believes that it is paying for the expertise and knowledge available from Retailer. Retailer believes Vendor is electing to purchase its knowledge of the market rather than internally developing such knowledge. Retailer would offer such services to a nonvendor.

Evaluation: The cash consideration received is in return for Retailer providing goods or services that provide an identifiable benefit to Vendor that is sufficiently separable from Retailer's purchase of Vendor's goods. Since Retailer offers those research services to a nonvendor and the fair value of the research services is determinable, the cash consideration received from the vendor represents revenue (or other income, as appropriate) and should be characterized as such when recognized in Retailer's income statement, provided that the cash consideration received does not exceed the estimated fair value of the benefit received by Vendor. If the amount of cash consideration paid by Vendor exceeds the estimated fair value of related benefits received, that excess amount should be characterized as a reduction of cost of sales when recognized in Retailer's income statement.

Example 3

On January 1, 20X1, in a binding arrangement, Vendor offers a cash refund of $1,000 to Customer if during the calendar year 2001, Customer purchases 1,000 units. Customer, on average, purchases 1,700 units each year.

Evaluation: Since Customer is entitled to the refund offered by Vendor based on the purchase of 1,000 units of inventory, Customer should accrue the refund offer over the purchase of the 1,000 units, provided that it is probable and reasonably estimable that Customer will purchase 1,000 units during 20X1.

Exhibit 02-16B

GLOSSARY

This exhibit contains definitions of certain terms used in this Issue.

Cash consideration
For purposes of this Issue, cash consideration includes cash payments and "credits" that the customer can apply against trade amounts owed to the vendor. In addition, under the consensus on Issue 2 of EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services," consideration in the form of equity instruments is recognized "in the same period(s) and in the same manner (that is, capitalize versus expense) as if the enterprise had paid cash for the goods or services or used cash rebates as a sales discount instead of paying with or using the equity instruments." Accordingly, for purposes of this Issue, guidance with respect to cash consideration is applicable to consideration that consists of equity instruments (regardless of whether a measurement date has been reached). For purposes of this Issue, cash consideration may be referred to by terms such as sales incentives, discounts, coupons, rebates, price reductions, and so forth.

Cooperative advertising
A vendor agrees to reimburse a customer for a portion of the advertising costs incurred by the customer. Cooperative advertising programs generally provide that a vendor will participate in the cost of a customer's advertising. The amount reimbursed to the customer typically is limited to a specified percentage of that customer's purchases from the vendor. The program may or may not require the customer to provide documentation of the actual costs incurred to advertise the vendor's products.

Customer
A reseller or a consumer (either an individual or a business that purchases a vendor's products or services for end use rather than for resale). Customer should be defined consistent with paragraph 39 of Statement 131, which states that "a group of entities known to a reporting enterprise to be under common control shall be considered as a single customer, and the federal government, a state government, a local government (for example, a county or municipality), or a foreign government each shall be considered as a single customer." For purposes of this Issue, customer includes any purchaser of the vendor's products at any point along the distribution chain, regardless of whether the purchaser acquires the vendor's products directly or indirectly (for example, from a distributor) from the vendor. For example, a vendor may sell its products to a distributor who in turn resells the products to a retailer. The retailer in that example is a customer of the vendor as that term is used in this Issue.

Reseller
Any entity that purchases another vendor's products for resale, regardless of whether that entity is a distributor or wholesaler, retailer, or other type of reseller.

Vendor
For purposes of this Issue, the term vendor is used to represent a service provider or product seller, such as a manufacturer, distributor, or reseller.

Issue No. 02-18

Title: Accounting for Subsequent Investments in an Investee after Suspension of Equity Method Loss Recognition

Dates Discussed: October 25, 2002; November 21, 2002; January 23, 2003

References: FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*

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

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

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

AICPA Accounting Interpretation 2, "Goodwill in a Step Acquisition," of APB Opinion No. 17, *Intangible Assets*

Proposed AICPA Statement of Position, *Accounting for Investors' Interests in Unconsolidated Real Estate Investments*, dated November 21, 2000

AICPA Technical Q&A 2220.14, "Equity Method—Effect of Unrecorded Equity in Losses on Additional Investment"

International Accounting Standard 28, *Accounting for Investments in Associates*

Standards Interpretations Committee 20, *Equity Accounting Method—Recognition of Losses*

Introduction

1. Paragraph 19 of Opinion 18 provides specific guidance on applying the equity method of accounting including the specific procedures relating to the losses of an investee. The investor's accounting for past and continuing operating losses of the investee follows Opinion 18, paragraph 19(i), which states:

> An investor's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by the equity method plus advances made by the investor. The investor ordinarily should discontinue applying the equity method when the investment (and net advances) is reduced to zero and should not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee. If the investee subsequently reports net income, the investor should resume applying the equity method only after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended. [Footnote reference omitted.]

2. *EITF Abstracts*, Topic No. D-68, "Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of an Investee," provides that Opinion 18 requires an investor who owns common (or other voting) stock and also (a) owns debt securities (including mandatorily redeemable preferred stock), (b) owns preferred stock, or (c) has extended loans to the investee, to continue to report losses.

3. As a result of Topic D-68, a question arose as to the interaction between the application of Opinion 18 on the recording of equity method losses (when the carrying amount of the common stock has been reduced to zero) and applicable literature relating to other investments in the investee (either Statement 114 or Statement 115). 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," addresses that question and indicates that in situations in which (a) an investor is not required to advance additional funds to the investee and (b) previous losses have reduced the common stock investment to zero, the investor should continue to report its share of equity method losses in its statement of operations to the extent of and as an adjustment to the adjusted basis of the other investments in the investee.

4. A subsequent question arose as to the proper accounting for subsequent investments in an investee after suspension of equity method loss recognition (assuming the guidance in paragraph 19(i) of Opinion 18 and Issue 98-13 have been appropriately applied).

5. *EITF Abstracts*, Topic No. D-84, "Accounting for Subsequent Investments in an Investee After Suspension of Equity Method Loss Recognition When an Investor Increases Its Ownership Interest from Significant Influence to Control through a Market Purchase of Voting Securities," provides the SEC staff's position on subsequent investments in an investee after suspension of equity method loss recognition when an investor increases its ownership interest from significant influence to control through a market purchase of voting securities. Topic D-84 states:

> ...in the circumstances in which an investor increases its ownership interest from one of significant influence to one of control through the purchase of additional voting securities in the market, and where no commitment or obligation to provide financial support existed prior to obtaining control, the acquisition should follow step acquisition accounting. Recognition of a "loss on purchase" or a restatement of prior-period financial statements is not appropriate.

6. Topic D-84 addresses when the additional investment in the investee results in an increase in ownership from significant influence to control; however, it does not specifically address subsequent investments in an investee that do *not* increase the ownership interest from one of significant influence to one of control (for example, from 25 percent to 45 percent).

7. Currently, the only guidance (although nonauthoritative) specifically addressing subsequent investments in an investee that do not increase the ownership interest from one of significant influence to one of control is included in TPA 2220.14. TPA 2220.14 states the following:

> Inquiry – Company A purchased 40 percent of Company B for $100,000. Company A did not guarantee the debt of Company B. Subsequent to the

> investment by A, B incurred large operating losses and A ceased to record equity in B's losses after its investment in B was reduced to zero. A few years later, A purchased an additional 5 percent interest in B. Should Company A offset the amount of this additional investment by the unrecorded equity in losses of Company B?
>
> Reply – No. Company A's additional investment would not be offset by the unrecorded equity in Company B's losses because A's unrecorded equity in those losses is not attributable to the block of shares in comprising the additional 5 percent interest.

Issues

8. The issues are:

Issue 1—Assuming an investor has appropriately suspended equity method loss recognition in accordance with both paragraph 19(i) of Opinion 18 and Issue 98-13, whether an investor should recognize any previously suspended losses when accounting for a subsequent investment in an investee that does not result in the ownership interest increasing from one of significant influence to one of control.

Issue 2—If it is determined in Issue 1 that the additional investment, in whole or in part, represents the funding of prior losses, whether all previously suspended losses should be recognized or whether only the previously suspended losses equal to the portion of the investment determined to be funding prior losses should be recognized.

Prior EITF Discussion

9. At the October 25, 2002 meeting, the Task Force discussed Issue 1 but did not reach a consensus. The Task Force asked the FASB staff to clarify that any consensus on Issue 1 would apply not only to additional investments in common (or other voting) stock but also to other investments including, but not limited to, preferred stock, debt securities, and loans to the investee.

10. The Task Force also observed that determining the appropriate accounting for an additional investment should depend on whether the additional investment is, in substance, the funding of prior losses. That determination may depend on the facts and circumstances of the investment, such as whether the additional investment is acquired from a third party or directly from the investee and whether the additional investment results in an increase in ownership interest. The Task Force asked the FASB staff to develop indicators that should be considered in determining whether, in substance, the additional investment is funding previous losses of the investee.

11. At the November 21, 2002 meeting, the Task Force discussed Issue 1 and certain indicators that should be considered in determining whether, in substance, the additional investment in an equity-method investee is funding previously suspended losses, but it did not reach a consensus. The Task Force asked the FASB staff to further develop and clarify those indicators.

12. The Task Force did not discuss Issue 2.

Current EITF Discussion

13. At the January 23, 2003 meeting, the Task Force reached consensuses on Issues 1 and 2 that if the additional investment, in whole or in part, represents, in substance, the funding of prior losses, the investor should recognize previously suspended losses only up to the amount of the additional investment determined to represent the funding of prior losses (refer to the second bullet of paragraph 14). Whether the investment represents the funding of prior losses, however, depends on the facts and circumstances.

14. The Task Force observed that judgment is required in determining whether prior losses are being funded and that all available information should be considered in performing the related analysis. The following are certain factors to consider in that regard. However, no one factor should be considered presumptive or determinative.

- Whether the additional investment is acquired from a third party or directly from the investee. When the additional investment is purchased from a third party and the investee does not obtain additional funds either from the investor or the third party, it is unlikely that, in the absence of other factors, prior losses are being funded.
- The fair value of the consideration received in relation to the value of the consideration paid for the additional investment. For example, if the fair value of the consideration received is less than the fair value of the consideration paid, it may indicate that prior losses are being funded to the extent that there is disparity in the value of the exchange.
- Whether the additional investment results in an increase in ownership percentage of the investee. In instances in which the investment is made directly with the investee, the investor should consider the form of the investment and whether other investors are making simultaneous investments proportionate to their interests. Investments made without a corresponding increase in ownership or other interests, or a pro rata equity investment made by all existing investors, may indicate that prior losses are being funded.
- The seniority of the additional investment relative to existing equity of the investee. An investment in an instrument that is subordinate to other equity of the investee may indicate that prior losses are being funded.

15. The Task Force also observed that, upon making the additional investment, the investor should evaluate whether it has become otherwise committed to provide financial support to the investee.

16. The Task Force indicated that it would provide guidance in a separate EITF Issue for determining whether, at the time of the additional investment, an investor becomes "otherwise committed" to provide financial support to an equity-method investee.

Transition

17. The guidance in this Issue should be applied to additional investments in equity-method investees made subsequent to February 5, 2003, and previously suspended cumulative losses existing at the time of that investment.

Board Ratification

18. At its February 5, 2003 meeting, the Board ratified the consensuses reached by the Task Force in this Issue.

Status

19. No further EITF discussion is planned.

Issue No. 03-1

Title: The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments

Dates Discussed: January 23, 2003

References: FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*

FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*

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

FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*

FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*

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

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

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

FASB Staff Implementation Guide, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities: Questions and Answers*

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

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*

AICPA Statement on Auditing Standards No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

AICPA Audit and Accounting Guide, *Banks and Savings Institutions*

SEC Staff Accounting Bulletin No. 59, *Accounting for Noncurrent Marketable Equity Securities*

International Accounting Standard 28, *Accounting for Investments in Associates*

International Accounting Standard 36, *Impairment of Assets*

International Accounting Standard 39, *Financial Instruments: Recognition and Measurement*

Standards Interpretations Committee 20, *Equity Accounting Method: Recognition of Losses*

Introduction

1. The impairment methodology for various types of investments accounted for in accordance with the provisions of Opinion 18 and Statement 115 is predicated on the notion of *other than temporary*. The term *other than temporary* is not defined by current authoritative literature, and little authoritative literature exists on other-than-temporary impairment. Some believe that the authoritative literature extant is ambiguous and has led to inconsistent application.

2. While investments accounted for in accordance with Opinion 18 and Statement 115 share certain similarities, they are also different in many respects. In spite of such differences, the FASB staff believes a common approach to evaluating other-than-temporary impairment to all such investments can be developed; a common approach would reduce ambiguity and inconsistent application.

Issues

3. The issue is to determine the meaning of other-than-temporary impairment and its application to investments accounted for under the cost method or the equity method, or as either available-for-sale or held-to-maturity under Statement 115.

Prior EITF Discussion

4. EITF Issue No. 02-14, "Whether the Equity Method of Accounting Applies When an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means," is a scope issue related to Opinion 18. In responding to that Issue, the FASB staff developed a view that recommended that the Task Force define *other-than-temporary* impairment and provide additional guidance on how other-than-temporary impairment should be applied to certain investments accounted for by the cost method under Opinion 18. At the September 11–12, 2002 meeting, the Task Force requested that the FASB staff develop views regarding the meaning of other-than-temporary impairment and its application to certain investments carried at cost.

5. At the November 21, 2002 meeting, the Task Force 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 U.S. GAAP 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 the issue be addressed by the Task Force separately from Issue 02-14.

Current EITF Discussion

6. At the January 23, 2003 meeting, the Task Force noted that several complex issues surround the application of other-than-temporary impairment. In light of those complex issues, the Task Force requested that a working group be established to develop an approach for assessing other-than-temporary impairment that would be appropriate for different types of investments.

Status

7. Further discussion is expected at a future meeting.

Issue No. 03-2

Title: Accounting for the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities

Date Discussed: January 23, 2003

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

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

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

FASB Special Report, *A Guide to Implementation of Statement 88 on Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits: Questions and Answers*

FASB Special Report, *A Guide to Implementation of Statement 106 on Employers' Accounting for Postretirement Benefits Other Than Pensions: Questions and Answers*

APB Opinion No. 20, *Accounting Changes*

Introduction

1. In Japan, many large corporations have Employees' Pension Fund plans (EPFs), which are defined benefit pension plans established under the Japanese Welfare Pension Insurance Law (JWPIL). These plans are composed of (a) a substitutional portion based on the pay-related part of the old-age pension benefits prescribed by JWPIL (similar to social security benefits in the United States) and (b) a corporate portion based on a contributory defined benefit pension arrangement established at the discretion of each employer. An employer with an EPF and its employees are exempted from contributions to Japanese Pension Insurance (JPI) that would otherwise be required if they had not elected to fund the substitutional portion of the benefit through an EPF arrangement. The EPF, in turn, pays both the corporate and the substitutional pension benefits to retired beneficiaries out of its plan assets. Benefits of the substitutional portion are based on a standard remuneration schedule as determined by JWPIL, but the benefits of the corporate portion are based on a formula determined by each employer/EPF. The plan assets of an EPF are managed/invested as a single portfolio for the entire EPF and are not statutorily attributed to the substitutional and corporate portions. The significance of the substitutional portion to the entire EPF varies. In some plans, the substitutional portion may account for as little as 10 percent of the total projected benefit obligation (PBO), while in others it may account for as much as 60 percent of the total PBO.

2. EPF arrangements have been in place in Japan since before the issuance of Statement 87. Upon the issuance of Statement 87, a number of Japanese companies had requested the SEC staff's views on the appropriate accounting for such arrangements under Statement 87. The SEC staff had, in turn, consulted with the FASB staff and concluded that EPF arrangements should be accounted for as single-employer defined benefit plans using a single plan approach.

3. In June 2001, the JWPIL was amended to permit each employer/EPF to separate the substitutional portion from its EPF and transfer the obligation and related assets to the government. Upon completion of the separation, the remaining substitutional obligation and related plan assets, determined pursuant to a government formula, are transferred to a government agency, and the employer/EPF is released from paying the remaining substitutional portion of the benefits to EPF beneficiaries. After the separation, both the employer and the employees are required to make periodic contributions to JPI, and the Japanese government is responsible for all benefit payments earned under JWPIL. The remaining portion of the EPF (that is, the corporate portion) continues to exist exclusively as a corporate defined benefit pension plan (CDBP), although, from a legal or regulatory perspective, the EPF is deemed to have been dissolved and a CDBP is deemed newly established when the separation process is completed. Subsequent to the separation process, an employer may transfer the remaining corporate portion of an EPF into a defined contribution plan.

4. The process of separating the substitutional portion from the corporate portion occurs in four phases, but the employer/EPF may not complete only certain parts of the separation process. Essentially, once an employer/EPF obtains Phase 2 approval, it must complete the entire separation process. Likewise, assuming the employer/EPF has obtained the requisite approval from the employees' representative, the separation is subject only to administrative processing by the government. The four phases are as follows:

Phase 1

An employer/EPF makes an application to the Japanese government for an exemption from the obligation to pay benefits for future employee service related to the substitutional portion. As a prerequisite in making that application, the representative of the employees covered by the plan must agree to the separation.

Phase 2

On or after April 1, 2002 (when the June 2001 amendment to JWPIL became effective), the Japanese government gives each employer/EPF an approval of exemption from the obligation for benefits related to future employee service under the substitutional portion. Once that approval is obtained, the employer begins making JPI payments directly to the government.

Phase 3

After obtaining an approval of exemption from the obligation for benefits related to future employee service under the substitutional portion, the employer/EPF must make another application for separation of the remaining substitutional portion (that is, the benefit obligation related to past services).

Phase 4

Within two-and-a-half years from the enactment date of the JWPIL amendment (June 15, 2001), the Japanese government will grant each employer/EPF the final approval of separation. On obtaining that approval, the remaining benefit obligation of the substitutional portion (that amount earned by past services) as well as the related government-specified portion of the plan assets of the EPF will be transferred to JPI.

Issue

5. The issue is how an employer should account for the separation of the substitutional portion of the benefit obligation of an EPF from the corporate portion and the transfer of the substitutional portion and related assets to the Japanese government.

Current EITF Discussion

6. At the January 23, 2003 meeting, the Task Force reached a consensus that the entire separation process should be accounted for upon completion of the transfer to the government of the substitutional portion of the benefit obligation and related plan assets (Phase 4) as the culmination of a series of steps in a single settlement transaction. This consensus is limited to the accounting for the separation of the substitutional portion of the benefit obligation from the corporate portion of the benefit obligation in a Japanese EPF arrangement and the transfer of the substitutional portion and related assets to the Japanese government pursuant to the June 2001 JWPIL amendment.

7. Under the consensus reached, at the time the assets are transferred to the government in an amount sufficient to complete the separation process, the transaction is considered to be complete and the elimination of the entire substitutional portion of the benefit obligation would be accounted for as a settlement at that time. Immediately prior to the separation, in accordance with Statement 88, the entire projected benefit obligation would be remeasured at fair value, including the effects of anticipated future salary increases.[1] In accounting for the settlement of the substitutional portion of the obligation, a proportionate amount of the Statement 87 net unrecognized gain or loss related to the entire EPF would be recognized as a settlement gain or loss. The proportionate amount of the net unrecognized gain or loss to be recognized would be determined based on the proportion of the projected benefit obligation settled to the total projected benefit obligation, both of which would exclude the previously accrued salary progression for purposes of that calculation. Subsequent to the separation, the remaining assets and obligation of the EPF, along with the unrecognized prior-service costs and gains and losses would continue to be accounted for pursuant to the requirements of Statement 87.

8. The difference between the obligation settled and the assets transferred to the government, determined pursuant to the government formula, should be accounted for and disclosed separately as a subsidy from the government pursuant to applicable generally accepted accounting principles. The derecognition of previously accrued salary progression at the time of settlement, pursuant to this consensus, should be accounted for and disclosed separately from the government subsidy.

9. Exhibit 03-2A illustrates the application of this consensus.

[1] That remeasurement would include the effects of any changes in actuarial assumptions as well as actual experience since the previous measurement date. The obligation would be measured at current market rates of interest that could be obtained in a transaction with a third-party, nongovernmental entity to settle the obligation. On the basis that the government had accepted responsibility for all substitutional benefits earned subsequent to Phase 2 approval, the remeasurement of the projected benefit obligation should include only benefits earned under the substitutional arrangement prior to Phase 2 approval.

Transition

10. This consensus should be applied retroactively to April 1, 2002, the earliest date on which the separation process could have begun. If the consensus is adopted in the same fiscal year that the separation process began, no cumulative effect shall be included in net income of the period of adoption. Instead, to the extent that the consensus affects previously issued financial statements for the pre-adoption interim periods of that fiscal year, those periods, when first presented for comparative purposes, should be restated and the related effects should be disclosed. If the consensus is adopted in a fiscal year subsequent to the fiscal year in which the separation process began, the effect of applying this consensus on previously issued financial statements should be reported and disclosed as a cumulative effect of a change in accounting principle as of the beginning of the year of adoption in accordance with the applicable provisions of Opinion 20.

Board Ratification

11. At its February 5, 2003 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

Status

12. No further EITF discussion is expected.

Exhibit 03-2A

ILLUSTRATION OF THE APPLICATION OF THE EITF CONSENSUS ON ISSUE 03-2

Total Employees Pension Fund	Before Separation[2]	Effect of Separation		After Separation
Accumulated benefit obligation	$ (10,500)	$ 5,000	a	$ (5,500)
Effects of projected future wage levels	(1,600)	750	b	(850)
Projected benefit obligation	(12,100)	5,750		(6,350)
Plan assets at fair value	6,420	(3,000)	c	3,420
Funded status	(5,680)	2,750	d	(2,930)
Unrecognized transition obligation	50	-		50
Unrecognized prior service cost (credit)	(540)	-		(540)
Unrecognized net (gain) / loss	4,405	(1,941)	e	2,464
Accrued pension cost	$ (1,765)	$ 809		$ (956)

[a] Assumed value of substitutional accumulated benefit obligation for purposes of illustration.
[b] Assumed value of future salary levels (salary progression) related to substitutional benefit obligation at time of settlement for purposes of illustration.
[c] Assumed value of assets required to be transferred to the government pursuant to the government formula for purposes of illustration.
[d] Difference between the fair value of the obligation "settled" with the government and the assets required to be transferred to the government. That amount, less the effect of the reversal of future salary progression ($750), is the government subsidy that should be separately accounted for and disclosed.
[e] Calculated as the ratio of the obligation settled ($5,000) to the total Employees Pension Fund obligation immediately prior to settlement ($11,350), both of which exclude the effect of future salary progression related to the substitutional portion, times the net unrecognized gain/loss immediately prior to settlement.

[2] Employee Pension Fund assets and obligations would be remeasured at fair value immediately prior to the separation transaction.

FASB EMERGING ISSUES TASK FORCE
Inventory of Open Issues
as of January 23, 2003

Issue Number	Issue	FASB Staff Assigned
98-4	Accounting by a Joint Venture for Businesses Received at Its Formation	Degano/ Munro
00-18	Accounting Recognition for Certain Transactions involving Equity Instruments Granted to Other Than Employees	Munro/ TBD
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	Martin/ Richards
01-8	Determining Whether an Arrangement Contains a Lease	Lynn/ Parrott
01-11	Application of EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," to a Contemporaneous Forward Purchase Contract and Written Put Option	Martin/ Lynn
01-J	Accounting for the Deconsolidation of a Majority-Owned Subsidiary	Tovey/ TBD
02-2	When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes	Martin/ Wilkins/ Richards
02-9	Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold	Lusniak/ Bullen/ Martin
02-14	Whether the Equity Method of Accounting Applies When an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means	Tovey/ Lynn
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*	Martin/ Lynn
02-J	Interpretation of an "Unconstrained Right to Pledge or Exchange" Transferred Assets in a Collateralized Bond Obligation	TBD

Issue Number	Issue	FASB Staff Assigned
02-L	Reporting Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and Not Held for Trading Purposes	Lynn/ Wilkins
03-1	The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments	Tovey/ Lynn
03-C	Accounting for Claims-Made Insurance Policies by the Insured Entity	TBD

EMERGING ISSUES TASK FORCE AGENDA COMMITTEE
Open Agenda Committee Items

Item		Comment
Issue 00-N, "Measuring Fair Value of Equity Securities with Restrictions in a Nonmonetary Exchange"		Pending further progress by the Board on its project Measuring All Financial Assets and Liabilities at Fair Value.
Application of Issue No. 99-20 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		Pending consideration of an FASB project that may address the measurement of beneficial interests in securitized financial instruments.
Accounting for Investments in Limited Liability Companies		Pending FASB staff consideration of issues relating to the accounting for investors' interests in unconsolidated real estate investments.

FASB EMERGING ISSUES TASK FORCE
Description of Open Issues
as of January 23, 2003

Issue 98-4, "Accounting by a Joint Venture for Businesses Received at Its Formation." Current practice generally has been to report the assets that a business contributes to a joint venture at historical cost unless certain conditions are met. APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, describes the characteristics of a "corporate joint venture." The issue is if two or more parties contribute businesses to a newly formed entity, whether the characteristics from Opinion 18, or some other characteristics, must exist in order for the entity to qualify for historical cost accounting. Transactions that are considered business combinations would require acquisition accounting.

Issue 00-18, "Accounting Recognition for Certain Transactions involving Equity Instruments Granted to Other Than Employees." EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services," addresses the measurement date from the standpoint of the entity granting equity instruments (the grantor). EITF Issue No. 00-8, "Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services," addresses the measurement date from the standpoint of the entity providing goods or services (the grantee). The issues are (a) the grantor's accounting for a contingent obligation to issue equity instruments (subject to vesting requirements) when a grantee performance commitment exists but the equity instrument has not yet been issued, (b) the grantee's accounting for the contingent right to receive an equity instrument when a grantee performance commitment exists prior to the receipt (vesting) of the equity instrument, and (c) for equity instruments that are fully vested and nonforfeitable on the date the parties enter into an agreement, the manner in which the issuer should recognize the fair value of the equity instruments.

Issue 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." Issue 98-5 addresses the accounting for convertible securities with a nondetachable conversion feature that is in-the-money at the commitment date. That Issue also addresses certain convertible securities that have a conversion price that is variable based on future events. Subsequent to the consensus, a number of practical issues on the application of the guidance in Issue 98-5 have arisen.

Issue 01-8, "Determining Whether an Arrangement Contains a Lease." Paragraph 1 of FASB Statement No. 13, *Accounting for Leases*, defines a lease as "an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time." It goes on to state that agreements that transfer the right to use property, plant, or equipment meet the definition of a lease even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets. There are divergent views and practices as to how to identify a lease in an arrangement that also provides for delivery of other goods or services by the seller (lessor). This Issue was originally raised by the Task Force during its deliberations on the accounting for energy trading activities. However, the issue of whether an arrangement contains a lease is not unique to energy-related contracts. The same issue may arise in outsourcing arrangements, such as the outsourcing of the data processing functions of an enterprise (it may be a significant element, particularly in those arrangements that require a substantial investment in computer hardware and terminals devoted solely to the use of a single customer); in the telecommunications industry where providers of network capacity (primarily in the form of conduit, fiber optic cables, and related equipment) often grant rights to capacity on the basis of an indefeasible right of use; and in some take-or-pay contracts involving certain commodities. The Issue is how to determine whether an arrangement contains a lease that is within the scope of Statement 13.

Issue 01-11, "Application of EITF Issue No. 00-19, 'Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock,' to a Contemporaneous Forward Purchase Contract and Written Put Option." Companies may contemporaneously enter into multiple contracts under Issue 00-19. Assume that a combined contract with economic characteristics that are substantially the same as the characteristics of the separate contracts would not meet the conditions for permanent equity classification in Issue 00-19. One such structure occurs when a company enters into a forward equity purchase contract on its own common stock and contemporaneously with the issuance of that forward equity purchase contract but in a separate agreement with the same counterparty, enters into a written put option on its own common stock with a strike price equal to the "changeover price." The issue is whether the company should account for the two contracts separately or whether the contracts should be combined for accounting purposes.

Issue 01-J, "Accounting for the Deconsolidation of a Majority-Owned Subsidiary." Paragraph 2 of FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, states that "the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty percent of the outstanding voting shares of another company is a condition pointing toward consolidation." The issue is whether a company that surrenders voting control of a majority-owned subsidiary but retains a majority of the risks and rewards of ownership should deconsolidate that subsidiary.

Issue 02-2, "When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes." Companies may, for various reasons, contemporaneously enter into multiple contracts that individually meet the definition of a financial instrument in paragraph 540 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The financial reporting impact of recording those contracts separately may be different from the financial reporting impact of recording those contracts on a combined basis. The issue is how to determine when separate contracts that meet the definition of financial instruments should be combined for accounting purposes.

Issue 02-9, "Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold." Paragraph 55 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires a transferor to recognize in its financial statements assets previously accounted for appropriately as having been sold when one or more of the conditions in paragraph 9 (regarding control of the assets) are no longer met. The transferor recognizes those assets together with liabilities to the former transferee(s) or beneficial interest holders in those assets and initially measures the assets and liabilities at fair value on the date of the change, as if the transferor purchased them on that date. The issue is how to apply the accounting requirements of paragraph 55 with respect to beneficial interests held by the transferor and loans that do not meet the definition of *security*, including whether the transferor should recognize a gain or loss when paragraph 55 is applied.

Issue 02-14, "Whether the Equity Method of Accounting Applies When an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means." Companies sometimes acquire the right to significantly influence the operations of another entity and/or share in a substantial portion of the economic risks and rewards of another entity without owning a voting interest in that entity. Often, under such arrangements, an entity may have some risk of ownership with respect to another entity without holding a voting ownership interest. The issue is when, if ever, and, if so, how a company should apply the equity method of accounting if it does not have an investment in the common stock of another entity yet is able to exercise significant influence over the operating activities of that entity.

Issue 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*." Paragraph 11(a) of Statement 133 provides that contracts issued or held by a reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position are not derivatives for purposes of applying Statement 133. EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock,'" addressed a number of common contractual provisions in which it was not clear whether the instrument met the condition of paragraph 11(a)(1) of Statement 133. However, some believe the guidance in that Issue does not apply with respect to dual indexation to a company's own stock and interest rates/credit risk given the provisions of Statement 133 with respect to convertible debt. The issue is whether instruments, other than convertible debt, that are indexed both to a company's own stock and to interest rates and the company's credit risk meet the condition in paragraph 11(a)(1) of Statement 133.

Issue 02-J, "Interpretation of an 'Unconstrained Right to Pledge or Exchange' Transferred Assets in a Collateralized Bond Obligation." Collateralized bond obligations (CBOs) are securitizations of high-yield debt, bank loan participations, or similar financial assets. The CBO issuing vehicle is a special-purpose entity (SPE), typically a corporation domiciled (for security law and tax reasons) in the Cayman Islands. The SPE is not a qualifying SPE (QSPE) because the conditions under which it can sell assets violate the provisions of *EITF Abstracts*, Topic No. D-66, "Effect of a Special-Purpose Entity's Powers to Sell, Repledge, or Distribute Transferred Financial Assets under FASB Statement No. 125." The SPE has, at all times, the discretion to hold or sell defaulted assets or assets deemed to be "credit risk" or "credit improved" assets. The SPE also can sell up to between 20 percent and 30 percent annually of the aggregate principal balance of collateral (as of the beginning of each year) (known in the industry as the "free trade basket") during the reinvestment period. The free trade basket is in addition to the SPE's ability to trade defaulted credit risk and credit improved securities so that if the collateral manager decided that 50 percent of the SPE's assets were "credit improved," the collateral manager would be able to trade 70 percent of the SPE's assets (assuming a 20 percent free trade basket) in that year. Paragraph 9(b) of Statement 140 provides that with respect to a transferee that is not a QSPE, no condition both constrains the transferee (or holder) from taking advantage of right to pledge or exchange the transferred assets and provides more than a trivial benefit to the transferor. If the constraint is not imposed by the transferor, as would be the case in a typical CBO structure, then that constraint may or may not provide more than a trivial benefit to the transferor. The issue is whether the "free trade basket" violates paragraph 9(b) of Statement 140 and therefore precludes sale treatment by the transferor.

Issue 02-L, "Reporting Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and Not Held for Trading Purposes." In EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," the Task Force reached a consensus to rescind EITF Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities." In doing so, however, it reached a consensus that all gains and losses (realized and unrealized) on derivative instruments within the scope of Statement 133 should be shown net in the income statement, whether or not settled physically, if the derivative instruments are held for trading purposes. However, there may be contracts within the scope of Statement 133 not held for trading purposes that warrant further consideration as to the appropriate income statement classification of the gains and losses. Although a derivative instrument may be physically settled (settled by delivering or receiving the underlying to the contract) and may qualify for "gross" reporting pursuant to EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent," a question arises as to whether the revenues and costs of sales should be reported on a gross basis or netted in the income statement. The issue is when, if ever, gains and losses on derivative contracts not held for trading purposes should be reported on a net basis.

Issue 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." In connection with its discussion of EITF Issue No. 02-14, "Whether the Equity Method of Accounting Applies When an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means," at the November 21, 2002 meeting, the Task Force 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 U.S. GAAP when developing its views. The Task Force also requested that the scope of the impairment issue be expanded to include equity investments and investments subject to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and that that issue be addressed by the Task Force as a separate EITF issue.

Issue 03-C, "Accounting for Claims-Made Insurance Policies by the Insured Entity." A claims-made insurance policy is one in which an entity is insured for any claims reported during the effective period of the policy. The claims may occur after the effective date of the policy and are reported while the policy is in force, or they may occur prior to the effective date of the policy and are reported while the policy is in force. *EITF Abstracts*, Topic No. D-79, "Accounting for Retroactive Insurance Contracts Purchased by Entities Other Than Insurance Enterprises," states that entities other than insurance enterprises should account for the purchase of retroactive insurance policies in a manner similar to the one in which reinsurance contracts are accounted for under FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*. When a claims-made policy is purchased with its prospective and retroactive components, the issue is whether an insured entity must apply Topic D-79 in all cases and, thus, always use the retroactive policy method of accounting described in Statement 113.