

**Emerging Issues Task Force  
Agenda Committee Report  
July 20, 2007**

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**Emerging Issues Task Force Agenda Committee  
Decisions on Proposed Issues**

**1. Consideration of Certain Terms in Derivative Contracts When Determining Whether an Instrument Is Indexed to a Company's Own Stock**

**Background**

Certain provisions in equity derivative contracts that companies enter into on their own stock may contain provisions for which it is not clear whether the contract is indexed solely to the company's own stock. For ease of discussion, the following fact pattern is based, in part, on the forward sale contract that is illustrated in paragraph 2 of EITF Issue No. 99-7, "Accounting for an Accelerated Share Repurchase Program," which is provided below. However, this issue is relevant to other equity derivative instrument on an issuer's own shares.

[On July 1, 1999,] Company A ... enters into a forward contract with Investment Banker on 1,000,000 shares of its own common stock. On the October 1, 1999 settlement date, if the volume-weighted average daily market price of Company A's common stock during the contract period (July 1, 1999 to October 1, 1999) exceeds the \$50 initial purchase price (net of a commission fee to Investment Banker), Company A will deliver to Investment Banker cash or shares of common stock (at Company A's option) equal to the price difference multiplied by 1,000,000. If the volume-weighted average daily market price of Company A's common stock during the contract period is less than the \$50 initial purchase price (net of a commission fee to Investment Banker), Investment Banker will deliver to Company A cash equal to the price difference multiplied by 1,000,000.

The forward contract in the example above stipulates that upon the occurrence of certain "Extraordinary Events" (for example, merger, tender offer, nationalization, insolvency, or delisting), the settlement of the forward sale contract will be based on the "Modified Calculation Agent Adjustment." For a definition of that term, the contract refers to the 2002 ISDA Equity Derivatives Definitions, which is a guide that provides definitions of common terms in equity derivative products and that is published by the International Swaps and Derivatives Association,

Inc., for the purpose of "[encouraging] the prudent and efficient development of the privately negotiated derivatives business" (ISDA Mission on [www.isda.org](http://www.isda.org)).

The actual definition of "Modified Calculation Agent Adjustment," as contained in the Equity Derivatives Definitions, is included below. In short, the Modified Calculation Agent Adjustment gives the Calculation Agent (which may be, for example, the investment bank that is the counterparty to the derivative contract) the unilateral ability to adjust the terms of the derivative contract if one or more specified events occur. Adjustments to the settlement terms must be made using commercially reasonable procedures and may include, at the Calculation Agent's (that is, the counterparty's) discretion, adjustments to account for changes in the:

- Company's stock price volatility
- Expected dividends on the company's shares
- Stock loan rate for the company's shares
- Liquidity relevant to the company's shares.

The Calculation Agent also has the ability to determine the effective date of such adjustments. Finally, if the Calculation Agent believes that no adjustments will produce a commercially reasonable result, the Calculation Agent can elect Cancellation and Payment. Under Cancellation and Payment, the Calculation Agent must determine the Cancellation Amount. In essence, the Cancellation Amount is meant to approximate the fair value or replacement value of the derivative contract, adjusted for costs of funding as well as any losses or costs incurred in terminating any hedge positions associated with the contract being cancelled.

Absent the provisions described above, and assuming that settlement in its common shares is within Company A's control (as described in paragraphs 12–32 of EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"), the contract would be classified in equity in accordance with paragraph 4 of EITF 99-7 and paragraph 46 of Issue 00-19.

## Accounting Issue and Alternatives

**Issue 1: Is incorporation of the Modified Calculation Agent Adjustment into Company A's forward contract consistent with the contract being indexed to Company A's own stock, as that term is defined in EITF Issue No. 01-6, "The Meaning of "Indexed to a Company's Own Stock"?**

*View A: Yes. The incorporation of the Modified Calculation Agent Adjustment as that term is defined below, is consistent with the forward contract being "indexed to a company's own stock" as that term is defined in Issue 01-6.*

Paragraph 5 of Issue 01-6 states, in part, the following:

The Task Force reached a consensus on Issue 2 that instruments within the scope of this Issue are considered *indexed to a company's own stock* within the meaning of Issue 00-19 and paragraph 11(a) of Statement 133 for the issuer provided that (1) the contingency provisions are not based on (a) an observable market, other than the market for the issuer's stock (if applicable), or (b) an observable index, other than those calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer, EBITDA [earnings before interest, taxes, depreciation, and amortization] of the issuer, net income of the issuer, or total equity of the issuer), and (2) once the contingent events have occurred, the instrument's settlement amount is based solely on the issuer's stock....

None of the Extraordinary Events that trigger the Modified Calculation Agent Adjustment are based on an observable market or observable index. Therefore, the first condition in paragraph 5 is met. Furthermore, once an Extraordinary Event has occurred, the settlement amount of the forward is based solely on the company's common stock.

In reaching this conclusion, proponents of View A note that the second condition in paragraph 5 refers to the issuer's stock, **not** the issuer's stock price. Proponents of View A observe that each of the items that may factor into the Modified Calculation Agent Adjustment (stock price volatility, expected dividends, stock loan rate, and liquidity of the company's shares) is derived from or pertains to the Company's stock and that once adjustments are made to the contract

terms, the ultimate settlement amount of the contract, which may not occur for some time, is based on the difference between the Company's stock price and the adjusted forward price.

*View B: No. The incorporation of the Modified Calculation Agent Adjustment, as that term is defined below, is inconsistent with the forward contract being "indexed to a company's own stock" as that term is defined in Issue 01-6.*

Proponents of View B acknowledge that paragraph 5 of Issue 01-6 uses the words "based solely on the issuer's stock" and not "...the issuer's stock price." However, proponents of View B believe that Exhibit A to Issue 01-6 is an integral part of Issue 01-6, illustrating the application of the consensus in paragraph 5 to four separate instruments. Proponents of View B believe that the Task Force's discussion of Instruments 1 and 2 illustrates what it means for the settlement amount of a derivative contract to be "based solely on the issuer's stock."

Exhibit A describes Instruments 1 and 2, in part, as follows:

*Instrument 1:* Company A issues warrants that permit the holder to buy 100 shares of its common stock at \$10 each, but those warrants *are* exercisable only if Company A has an initial public offering. For Company A, those warrants are considered to be indexed to its own stock within the meaning of Issue 00-19 and paragraph 11(a) of Statement 133 because (1) the contingent event (that is, the initial public offering) is not an observable market or an observable index and (2) once the contingent event occurs, the warrant's settlement amount is based solely on Company A's stock. **That is, once the initial public offering occurs, the warrant's value is determined as the product of 100 shares multiplied by the difference between the market price of Company A's stock at settlement and \$10.**

*Instrument 2:* Company A issues warrants that permit Company B to buy 100 shares of its common stock at \$10 each over the next 3 years after Company A accumulates \$100,000 in sales to third parties. For Company A, those warrants *are* considered to be indexed to its own stock within the meaning of Issue 00-19 and paragraph 11(a) of Statement 133 because (1) even though the contingent event (that is, the accumulation of \$100,000 in sales to third parties) is an observable index, it can only be calculated or measured by reference to Company A's sales and (2) once the contingent event occurs, the warrant's settlement amount is based solely on Company A's stock. **That is, the warrant's value at the settlement date is determined as the product of 100 shares multiplied by**

**the difference between the market price of Company A's stock at settlement and \$10.** [Emphasis added.]

The two examples in Exhibit A above seem to indicate that the second condition of paragraph 5 of Issue 01-6 should be interpreted to mean that "once the contingent events have occurred, the instrument's settlement [*value*] is based solely on the issuer's own stock [*price*]." Because the counterparty has the right to adjust the forward price upon an Extraordinary Event for changes in volatility, expected dividends, stock loan rate, and stock liquidity, the settlement value is based not only on Company A's common stock price on date of settlement but also on any one of those other factors, as determined by the counterparty. Accordingly, Proponents of View B believe that the forward sale contract fails the second condition of paragraph 5 of Issue 01-6 and would therefore be outside the scope of Issue 00-19.

As further support for their position, proponents of View B observe that Modified Calculation Agent Adjustments are typically included in derivative contracts to protect the counterparty from the economic consequences of events for which the probability of occurrence was deemed remote at inception of the contract. On the assumption that the probability of such events occurring is in fact remote, counterparties typically ignore those events when determining the pricing (that is, forward price) of a forward contract. Thus, Modified Calculation Agent Adjustments allow the counterparty to make itself "whole" for the occurrence of unexpected events and the impact that such events have on the variables that factor into pricing a contract (for example, volatility and dividend expectations).

Proponents of View B believe that when taken as a whole, the criteria for equity classification set forth in paragraphs 12–32 are designed to ensure that contract holders do not have rights that are greater than those of a shareholder. In this case, the derivative counterparty is receiving a value adjustment that all of the existing shareholders are not entitled to. To support this view, proponents point to paragraph 27 of Issue 00-19, which states, in part:

Generally, if an event that is not within the company's control could require net-cash settlement, then the contract must be classified as an asset or a liability. However, if the net-cash settlement requirement can only be triggered in circumstances in which the holders of the shares underlying the contract also

would receive cash, equity classification would not be precluded. For example, an event that causes a change in control of a company is not within the company's control and, therefore, if a contract requires net-cash settlement upon a change in control, the contract generally must be classified as an asset or a liability. **However, if a change-in-control provision requires that the counterparty receive, or permits the counterparty to deliver upon settlement, the same form of consideration (for example, cash, debt, or other assets) as holders of the shares underlying the contract, permanent equity classification would not be precluded as a result of the change-in-control provision.** In that case, if the holders of the shares underlying the contract were to receive cash in the transaction causing the change in control, the counterparty to the contract could also receive cash based on the value of its position under the contract. If instead of cash, holders of the shares underlying the contract receive other forms of consideration (for example, debt), the counterparty also must receive debt (cash in an amount equal to the fair value of the debt would not be considered the same form of consideration as debt). Similarly, a change-in-control provision could specify that if all stockholders receive stock of an acquiring company upon a change in control, the contract will be indexed to the shares of the purchaser (or issuer in a business combination accounted for as a pooling of interests) specified in the business combination agreement, without affecting classification of the contract.

With regards to this last point, opponents of View B point out that the additional criteria for equity classification in paragraphs 12–32 of Issue 00-19 were intended solely to ensure that Issue 00-19's equity settlement conditions were met. As support for their position, opponents of View B point to paragraph 13 of Issue 00-19, which states in part:

Because any contract provision that could require net-cash settlement precludes accounting for a contract as equity of the company (except for those circumstances in which the holders of the underlying shares would receive cash, as discussed in paragraphs 27 and 28), all of the following conditions must be met for a contract to be classified as equity.

**Issue 2: Are the factors included in the Cancellation and Payment provision of Company A's forward contract (such as compensation for cost of funds or costs of terminating hedges) consistent with the contract being indexed to Company A's own stock, as that term is defined in Issue 01-6?**

*View A: Yes. The incorporation of Cancellation and Payment as that term is defined below, is consistent with the forward contract being "indexed to a company's own stock" as that term is defined in Issue 01-6.*

As described in the fact pattern above, if upon the occurrence of an Extraordinary Event, the calculation agent determines that no adjustments will produce a commercially reasonable result, the calculation agent may elect Cancellation and Payment. In this instance, the Calculation Agent must determine the Cancellation Amount, which is meant to approximate the fair value of the contract adjusted for cost of funds and hedge breakage costs (which may include counterparty hedge losses).

Proponents of View A concede that some view **explicit** adjustments for costs of funds as a dual indexation issue. However, proponents of View A counter that all derivative contracts already have an **implicit** cost of funds component to them as evidenced by the fact that forward prices are typically higher than spot prices for an underlying. Therefore, Proponents of View A do not believe that cost of funds adjustments are inconsistent with equity classification. With regards to hedge termination costs, proponents of View A note that a rational counterparty would hedge a long or short position created by a forward contract using other derivative instruments that are indexed to the Company's own stock. Therefore, proponents of View A do not believe that the inclusion of hedge termination costs should prevent a contract from being considered "indexed to a company's own stock" as that term is defined in Issue 01-6.

*View B: No. The incorporation of Cancellation and Payment as that term is defined below, is not consistent with the forward contract being "indexed to a company's own stock" as that term is defined in Issue 01-6.*

Proponents of View B acknowledge that all derivative contracts have an implicit cost of funds component to them. View B proponents believe that a dual indexation does not result from cost of funds components to the extent that they are determined at inception and fixed for the duration of the contract. Proponents of View B do believe, however, that variable cost of funds

components present in a dual indexation that is inconsistent with a contract, be indexed to a company's own stock as that term is defined in Issue 01-6.

With regards to hedge breakage costs, proponents of View B assert that including compensation for such costs in the Cancellation Amount of a contract introduces another index to the contract's settlement amount, that being the hedging activities of the counterparty. For instance, proponents of View B observe that if several different counterparties were instructed to hedge the same long position in a company's stock, each counterparty would likely develop a different hedging strategy based on its individual risk tolerance, as well as its own expectations with regards to stock price volatility, stock liquidity, cost of funds, and dividend declarations. As a result, proponents of View B believe that the amount of hedge breakage costs incurred will differ by counterparty. View B proponents point to this as the basis that hedge breakage cost provisions are inconsistent with the concept of a contract being indexed to a company's own stock as that term is defined in Issue 01-6.

### **Additional Considerations**

This potential agenda item focuses on two provisions in the 2002 ISDA Equity Derivatives Definitions that highlight the difficulty of determining whether a contract is "indexed solely to an issuer's own stock," as that term is relevant to being in the scope of Issue 00-19 and paragraph 11(a) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. For illustrative purposes this discussion is limited to the two features described above. However, constituents struggle to apply the "indexed to a company's own stock" criteria to many features that are common to equity derivative instruments, such as:

- Warrants that have a strike price denominated in a currency other than the issuer's functional currency
- Warrants that have a strike price denominated in a currency other than the currency of the primary exchange on which the issuer's shares trade
- Forward contracts that have a forward price that increases on a daily basis by the overnight Fed Funds rate (as opposed to a forward price that is determined based on the interest rate environment on the date the contract is entered into)

- Adjustments to the settlement amount to cover transaction costs (for example, legal fees)
- Adjustments to the settlement amount that are triggered by tax indemnifications common to contracts documented under ISDA Master Agreements.

While the above list is not exhaustive, the Task Force may wish to consider the effect that any conclusions would have on the extensive variety of potential settlement amount adjustments that currently exist in the equity derivative markets.

### **Select ISDA Equity Derivatives Definitions**

The 2002 ISDA Equity Derivatives Definitions guide defines "Modified Calculation Agent Adjustment" as follows:

...[O]n or after the relevant [Event] Date, the Calculation Agent shall either (i)(A) make such adjustments to the exercise, settlement, payment or any other terms of the Transaction (including, without limitation, the spread) **as the Calculation Agent determines appropriate to account for the economic effect on the Transaction of such ... Event (including adjustments to account for changes in volatility, expected dividends, stock loan rate or liquidity relevant to the Shares or to the Transaction)**, ... and (B) determine the effective date of that adjustment, or (ii) if the Calculation Agent determines that no adjustment that it could make under (i) will produce a commercially reasonable result, notify the parties that the relevant consequence shall be the termination of the Transaction, in which "Cancellation and Payment" will be deemed to apply and any payment to be made by one party to the other shall be calculated in accordance with Section 12.7.... [Emphasis added.]

Section 12.7(c) of the ISDA Equity Derivatives Definitions defines "Cancellation and Payment," in part, as follows:

For any Forward Transaction..., such Transaction shall be cancelled and the relevant party or parties (as specified below) shall determine the Cancellation Amount in respect of such cancelled Transaction.

- i. In respect of a cancelled Transaction where there is one Determining Party, the Determining Party will calculate the Cancellation Amount and will determine which party will pay such amount.

ii. In respect of a cancelled Transaction where there are two Determining Parties, each party will calculate a Cancellation Amount and an amount will be payable equal to one-half of the difference between the Cancellation Amount of the party with the higher Cancellation Amount ("X") and the Cancellation Amount of the party with the lower Cancellation Amount ("Y") and Y shall pay it to X.

Assume that for this fact pattern, the confirmation specifies that the transaction has only one "Determining Party" and that such party is the Investment Banker. The definition of "Cancellation and Payment" above labels the settlement amount as the "Cancellation Amount," which is a term defined in Section 12.8 of the ISDA Equity Derivatives Definitions as follows (emphasis added):

- (a) "Cancellation Amount" means, with respect to a Determining Party, the amount of the losses or costs of the Determining Party that are or would be incurred under then prevailing circumstances (expressed as a positive number) or gains of the Determining Party that are or would be realized under then prevailing circumstances (expressed as a negative number) in replacing, or in providing for the Determining party the economic equivalent of, (i) the material terms of the relevant Transaction, including the payments and deliveries by the parties under the ISDA Master Agreement in respect of the relevant Transaction that would, but for the occurrence of the ... Event, have been required on or after the date that the Transaction is, or is deemed to have been, terminated or cancelled (assuming satisfaction of any applicable conditions precedent in the ISDA Master Agreement)...
- (b) Any Cancellation Amount will be determined by the Determining Party (or its agent), which will act in good faith and use commercially reasonable procedures in order to produce a commercially reasonable result. Each Cancellation Amount will be determined as of the date that the Transaction terminated or cancelled or, if that would not be commercially reasonable, as of the date or dates following the date that the Transaction terminated or cancelled as would be commercially reasonable.
- (c) In determining a Cancellation Amount, the Determining Party may consider any relevant information, including, without limitation, one or more of the following types of information:
  - i. **Quotations (either firm or indicative) for replacement transactions supplied by one or more third parties that may take into account the current creditworthiness of the Determining Party** at the time of quotation is provided and the terms of any relevant documentation, including credit support documentation, between the Determining Party and the third party providing the quotation;

- ii. Information consisting of relevant market data in the relevant market supplies by one or more third parties **including, without limitation, relevant rates, prices, yields, yield curves, volatilities, spreads, correlations or other relevant market data in the relevant market;**  
or
  - iii. Information of the types described in (i) or (ii) above from internal sources (including any Affiliates of the Determining Party) if that information is of the same type used by the Determining Party in the regular course of its business for the valuation of similar transactions.
- (d) The Determining Party will consider, taking into account the standards and procedures described in this definition, quotations pursuant to Section 12.8(c)(i) above or relevant market data pursuant to Section 12.8(c)(ii) above unless the Determining Party reasonably believes in good faith that such quotations or relevant market data are not readily available or would produce a result that would not satisfy those standards. **When considering information described in Section 12.8(c)(i), (c)(ii) or (c)(iii) above, the Determining Party may include costs of funding, to the extent costs of funding are not and would not be a component of the other information being utilized...**
- (e) Without duplication of amounts calculated based on information described in Section 12.8(c)(i), (c)(ii) or (c)(iii) above, or relevant information, and when it is commercially reasonable to do so, **the Determining Party may in addition consider in calculating a Cancellation Amount any loss or cost incurred in connection with its terminating, liquidating or re-establishing any hedge related to such Transaction (or any gain resulting from any of them).**

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

*Additionally, the Agenda Committee recommended that the scope of this issue be expanded to include practice concerns encountered when determining whether an instrument is indexed to a company's own stock including consideration of the derivative definitions established by ISDA and market-based employee stock option valuation instruments.*

## **2. Accounting for the Sale of Real Estate to an Entity When the Agreement between the Investors Includes a Buy-Sell Clause**

### **Background**

Buy-sell clauses provide investors with an exit strategy for closely held investments. Frequently, a buy-sell clause in the form described in the following paragraphs is included in an agreement between investors.

Two investors (Investor A and Investor B) form an entity. Investor A sells real property to that entity. The agreement between the investors includes a buy-sell clause, which provides that either investor may request a buy-out of the other party's interest by providing notice (the "Purchase Notice") to the other party. The party providing Purchase Notice is referred to as the "Offeror" and the receiving party is the "Offeree."

The Purchase Notice constitutes an irrevocable offer by the Offeror to buy the Offeree's entire interest in the entity. In the Purchase Notice, the Offeror names a price for the Offeree's equity at its discretion (the "Named Price"). Upon receipt of the Purchase Notice, the Offeree can elect to either sell its interest in the entity to the Offeror or buy the Offeror's interest.

Except for the potential impact of the buy-sell clause discussed above, the transaction meets the criteria for partial sale and profit recognition in paragraphs 33–36 of FASB Statement No. 66, *Accounting for Sales of Real Estate*.

### **Accounting Issue and Alternatives**

**Issue: Does a buy-sell clause in the form discussed above preclude partial sale and profit recognition pursuant to paragraph 26 of Statement 66 (that is, does it constitute an "option" or other form of prohibited continuing involvement)?<sup>1</sup>**

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<sup>1</sup> Note that the arrangement described above would constitute prohibited continuing involvement in a sale-leaseback transaction. A partial sale of real estate, as described in this Report, constitutes continuing involvement in a sale-leaseback transaction involving real estate pursuant to paragraph 13(c) of FASB Statement No. 98, *Accounting for Leases*, since the seller-lessee has retained an interest in the buyer-lessor, which allows the seller-lessee to participate in any future profit of the buyer-lessor or the appreciation of the leased property. The issue of a partial sale-leaseback is also addressed in *EITF Abstracts*, Topic No. D-24, "Sale-Leaseback Transactions with Continuing Involvement."

*View A: A buy-sell clause in the form discussed above constitutes an option or other form of prohibited continuing involvement, which in and of itself precludes partial sale and profit recognition pursuant to paragraph 26 of Statement 66.*

Proponents of View A point out that neither Statement 66 nor FASB Statement No. 98, *Accounting for Leases*, distinguishes between contingent and noncontingent options, nor do these Statements require or permit an evaluation of the probability of exercise of an unconditional option. A buy-sell clause in an agreement between investors is akin to a contingent option and, thus, should be treated like an option under paragraph 26 of Statement 66. Accordingly, Investor A should account for the sale of the real estate property to the entity as a financing, leasing, or profit-sharing arrangement pursuant to the provisions of paragraph 26 of Statement 66.

Proponents of View A cite the consensus in Question 2 of EITF Issue No. 97-1, "Implementation Issues in Accounting for Lease Transactions, including Those involving Special-Purpose Entities," which supports their view that an arrangement does not need to convey to a party the unilateral ability to trigger a buy or sale to be considered an option. Question 2 of Issue 97-1 states, in part:

An option on the part of the buyer-lessor to put the leased property to the seller-lessee in the event of a default by the seller-lessee is tantamount to a purchase option by the seller-lessee because it would be within the **control of the seller-lessee to economically compel the buyer-lessor to put the leased property to the seller-lessee** (for example, if the seller-lessee ceased making its scheduled lease payments). [Emphasis added.]

While Issue 97-1 is written in the context of sale-leaseback transactions, proponents of View A believe that the concept expressed in Question 2 of Issue 97-1 equally applies to real estate sale transactions. Proponents of View A point out that by being able to determine the exercise price of the option, the Offeror can highly influence the outcome of the buy-sell clause, that is, economically compel the other party to take a certain course of action. By setting the Named Price for the entity above fair value, the other member would be more likely to sell its interest in the entity to the Offeror. Alternatively, by setting the Named Price for the entity below its fair value, the other party would be more likely to purchase the Offeror's interest.

As such, they believe that a buy-sell clause in the form described above should be viewed as being analogous to a buyer-lessor's put option upon seller default discussed in Question 2 of Issue 97-1; in both circumstances, it is within the seller's control to economically compel the buyer to put the property back to the seller.

*View B: A buy-sell clause in the form described above does not in and of itself constitute an option or other form of prohibited continuing involvement, which precludes partial sale and profit recognition pursuant to paragraph 26 of Statement 66.*

Proponents of View B believe that a buy-sell clause in the form described above does not meet the definition of an option. A call option conveys the unconditional right to the seller to repurchase the real estate sold; a put option conveys the unconditional right to the buyer to sell the real estate back to the seller. A buy-sell clause, on the other hand, does not convey unconditional rights because the outcome is not known; that is, the Offeree may either sell its interest to the Offeror or buy the Offeror's interest in the entity.

As such, proponents of View B believe that the evaluation of whether a buy-sell clause in an arrangement between investors constitutes a form of prohibited continuing involvement under Statement 66 should be based on the facts and circumstances of the arrangement, which will require significant judgment.

Proponents of View B acknowledge the parallel fact pattern described in Question 2 of Issue 97-1; however, they note that neither Statement 98 nor Issue 97-1 is applicable to a buy-sell clause in an agreement between investors as there is no lease-back of the property sold. As such, Investor A must look to the guidance in Statement 66, rather than Statement 98. Statement 98 precludes sale-leaseback accounting if **any** continuing involvement other than a normal leaseback is present, whereas Statement 66 precludes sale accounting only if there is **substantial** continuing involvement.

Proponents of View B believe that when determining whether a buy-sell clause in a particular arrangement constitutes **substantial** continuing involvement, the totality of the arrangement needs to be analyzed.

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

### **3. Presentation of Historical Periods When Reporting Transactions between Entities under Common Control**

#### **Background**

FASB Statement No.141, *Business Combinations*, states that a business combination, as defined, excludes transfers of net assets or exchanges of equity interests between entities under common control. However, Appendix D of Statement 141 provides examples of those types of transactions and accounting guidance for them. In these situations, paragraph D12 requires the entity that receives the net assets or the equity interests to initially recognize the assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer.

Statement 141 also includes procedural guidance for presenting transactions between entities under common control and states that the method many entities have used in practice to account for those transactions is similar to the pooling method. Accordingly, paragraphs D15–D18 provide procedural guidance that should be considered when preparing financial statements for the entity that receives the net assets.

In some situations, one of the entities under common control may not have been under control of the common parent for all of the periods that are required to be presented. Consider the following facts and circumstances:

- Investor acquired 100 percent of Company A, an operating business, on January 1, 2002.
- Investor acquired 100 percent of Company B, also an operating business, on January 1, 2005.
- On July 1, 2005, Company B became an SEC registrant through the issuance of public debt. Company A is not an SEC registrant.
- During 2005, Investor considered the benefits of combining Company A and Company B. Based on the expected benefits identified, on January 1, 2006, Investor combined Company A and Company B through the form of Company B's acquiring from Investor all the outstanding shares of Company A for shares of Company B. Company B has remained an SEC registrant as the public debt has remained outstanding. At the time of the combination,

Company B was determined to be substantially larger than Company A on the measures of assets, revenues, and earnings. Senior management of Company B will serve as the senior management of the combined Company A and Company B.

- The combination of Company A and Company B is determined to be a common control transaction with assets and liabilities transferred to be recognized at their carrying amounts.
- Assume combined Company A and B financial statements are required for the calendar years ending 2004, 2005, and 2006.

### **Accounting Issue and Alternatives**

**Issue: When presenting combined Company A and B financial statements for the periods required, how should the combined financial statements reflect the historical amounts of Company A and Company B?**

*View A: Determine the historical entity based on which entity receives the net assets or equity interests.*

Proponents of this view argue that only one of the combining entities should be presented as the historical entity for periods prior to common control with that entity determined based on the form of the combination. Proponents of this view note that the procedural guidance in paragraphs D16 and D17 of Statement 141 offers guidance focusing on the "receiving entity." Proponents of this view argue that the reference to "receiving entity" emphasizes the importance of form to the reporting determination. They note that the term "receiving entity" was added when the guidance was carried forward from APB Opinion No. 16, *Business Combinations*. Additionally, proponents of this view argue that other guidance for common control combinations found in EITF Issue No. 90-5, "Exchanges of Ownership Interests between Entities under Common Control," and FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations, Including Costs of Closing Duplicate Facilities of an Acquirer, Stock Transactions between Companies under Common Control, Downstream Mergers, Identical Common Shares for a Pooling of Interests, Pooling of Interests by Mutual and Cooperative Enterprises*, is based on the form of the combination with no discussion to consider an alternative to that form.

The application of View A would result in the presentation of Company A and Company B as combined for periods after January 1, 2005 (the point in time the entities came under common control) and the presentation solely of Company B for periods prior to January 1, 2005, as the form of the combination was Company B acquiring Company A.

*View B: Determine the historical entity based on which combining entity was first acquired by the controlling shareholder.*

Proponents of this view argue that only one of the combining entities should be presented as the historical entity for periods prior to common control with that entity determined as the first entity acquired by the controlling shareholder. Proponents of this view argue that presenting the historical entity as the first entity acquired by the controlling shareholder appropriately presents the transaction from the perspective of the controlling shareholder. Proponents of this view argue that the perspective of the controlling shareholder is appropriate because the controlling shareholder determines whether the entities are combined or remain separate. Proponents further argue that presenting the transaction consistent with the perspective of the controlling shareholder is consistent with the requirement in Issue 90-5 to report the controlling shareholder's basis for the assets and liabilities transferred.

The application of View B would result in the presentation of Company A and Company B as combined for periods after January 1, 2005 (the point in time the entities came under common control) and the presentation solely of Company A for periods prior to January 1, 2005, as Investor acquired Company A before Company B. Because Company B is an SEC registrant, this will require the historical financial statements of Company B to be replaced with those of Company A analogous with a reverse acquisition. This view was expressed by the SEC staff at the December 12, 2006 AICPA National Conference on Current SEC and PCAOB Developments in the context of form and content requirements of financial statements for IPOs.

*View C: Determine the historical entity based on the facts and circumstances present.*

Proponents of View C agree with proponents of View A and View B that only one of the combining entities should be presented as the historical entity but argue that there should be no absolute indicator as to the historical entity. Instead, proponents of this view argue that the determination of the historical entity should be based on an evaluation of all pertinent facts and circumstances including:

1. The form of the combination (see View A)
2. The first entity acquired by the controlling shareholder (see View B)
3. Relative sizes of the combining entities considering a number of measures, such as assets, revenues, and earnings
4. The historical uses of the financial statements of each combining entity.

With regard to Item 3 above, proponents of this view argue that determining the historical entity in a common control combination is similar to identifying the acquiring entity in a purchase business combination. Paragraphs 17 and 18 of Statement 141 provide guidance on identifying the acquiring entity in a purchase business combination. Specifically, paragraph 18 suggests consideration of "whether the assets, revenues, and earnings of one of the combining entities significantly exceed those of the others." Additionally, paragraph 17 of Statement 141 suggests other facts and circumstances that may be pertinent, such as the composition of senior management. Proponents of this view also argue that the historical uses of the financial statements of each combining entity may be a pertinent fact. They argue that in the fact pattern presented, the existence of continuing investors in the combined entity that based an investment decision on the historical financial information (Investors in the Debt of Company B) of that entity is support that treating those financial statements (Company B) as the historical financial statements would be more relevant.

The application of View C would result in the presentation of Company A and Company B as combined for periods after January 1, 2005 (the point in time the entities came under common control), and the presentation solely of Company B for periods prior to January 1, 2005, based on

an analysis of all pertinent facts and circumstances. In this case, despite the fact that Company A was acquired first by Investor, the form of the combination, relative sizes of the combining entities, and historical use of the Company B financial statements for the issuance of debt to third parties who remain as investors in the combined entity each support Company B as the historical entity. Based on this evaluation of pertinent facts and circumstances, Company B is presented as the historical entity for periods prior to common control by Investor.

### **Alternative View Not Presented**

The guidance in Appendix D to Statement 141 is being carried forward to Statement 141(R) without reconsideration but with certain proposed clarifying adjustments including the sentence; "However, the comparative information in prior years should only be adjusted for periods during which the entities were under common control." Without this clarifying sentence, a literal read of Statement 141 could result in a view that the combined financial statements of Companies A and B should include historical amounts for both entities for all periods presented, including periods when one or both of the entities were not under common control. This view is based on the guidance in paragraph D14 of Statement 141, which states, in part:

Some transfers of net assets or exchanges of shares between entities under common control result in a change in the reporting entity. In practice, the method that many entities have used to account for those transactions is similar to the **pooling method**. Certain provisions in Opinion 16 relating to application of the pooling method provide a source of continuing guidance on the accounting for transactions between entities under common control. [Emphasis added.]

As a result of the proposed clarifying adjustment to Statement 141(R), this view, if eventually selected by the EITF, would only be applicable until Statement 141(R) is effective. Accordingly, the staff has elected not to present this view to the Agenda Committee.

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

**FASB EMERGING ISSUES TASK FORCE**  
**Proposed September 11, 2007 Meeting Agenda**

<u>Issue Number</u>	<u>Issue</u>	<u>Proposed Time</u>	<u>Staff Assigned</u>
07-E	Determining Whether an Instrument is Indexed to a Company's Own Stock	9:00–10:30	Stevens/ Malcolm
	* * * BREAK * * *	10:30–10:45	
07-4	Application of the Two-Class Method under FASB Statement No. 128, <i>Earnings per Share</i> , to Master Limited Partnerships	10:45–11:40	Wyatt/Sarno
	Administrative Matters	11:40–12:00	Paul
	- New Issues		
	- Other Matters		
	* * * LUNCH * * *	12:00–1:00	
	Closed Administrative Session	1:00-1:30	
07-1	Accounting for Collaborative Arrangements	1:30-2:30	Bolash/Paul
	* * * BREAK * * *	2:30–2:45	
07-F	Accounting for the Sale of Real Estate to an Entity When the Agreement between the Investors Includes a Buy-Sell Clause	2:45–3:45	TBD/Wyatt

### Status of Open Issues and Agenda Committee Items

The following represents the FASB staff's assessment of the status and immediate plans with respect to the open Issues on the Task Force's agenda. The Issues on the proposed agenda for the September 11, 2007 meeting are considered either high priority issues or issues on which meaningful progress can be made within the staff's given complement of resources. The staff's prioritization of issues is based primarily on the FASB staff's understanding of the level of diversity in practice created by each respective Issue, the financial reporting implications of that diversity, the current interaction, if any, of the Issues with active Board projects, and current resource availability among the staff (with respect to both time and relevant technical expertise).

<b>Issue No.</b>	<b>Description</b>	<b>Date Added</b>	<b>Date(s) Discussed</b>	<b>Next Meeting</b>	<b>EITF Liaison</b>	<b>FASB Staff</b>	<b>Immediate Plans</b>	<b>Due Date - Next Deliverable</b>
07-1	Accounting for Collaborative Arrangements Related to the Development and Commercialization of Intellectual Property	8/06	3/07, 6/07	9/07	Schroeder	Bolash/ Paul	The FASB staff will develop examples to illustrate Issue 3 for a future meeting.	September 11, 2007 EITF meeting
07-4	The Application of the Two-Class Method to Master Limited Partnerships under FASB Statement No. 128, <i>Earnings per Share</i> .	4/07	6/07	9/07	Bielstein	Wyatt/ Sarno	The FASB staff will prepare an Issue Summary for a future meeting	September 11, 2007 EITF meeting

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
00-27	Application of EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," to Certain Convertible Instruments	5/00	11/00, 1/01	Not scheduled	TBD	Pending further progress on Phase II of the Board's liabilities and equity project.	N/A
02-D	The Effect of Dual-Indexation both to a Company's Own Stock and to Interest Rates and the Company's Credit Risk in Evaluating the Exception under Paragraph 11(a)(1) of FASB Statement No. 133, <i>Accounting for Derivative Instruments and Hedging Activities</i>	3/02	N/A	Not scheduled	Jacobs	Pending further progress on Phase II of the Board's liabilities and equity project.	N/A

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
03-15	Interpretation of Constraining Conditions of a Transferee in a Collateralized Bond Obligation Structure	11/02	N/A	Not scheduled	Lusniak	The Board's project on QSPE's is not expected to address this Issue and, therefore, the FASB staff will bring this Issue to the Agenda Committee at a future meeting to determine whether to begin discussions on this Issue or to request that the Task Force remove this Issue from the agenda.	Future Agenda Committee or EITF Meeting
06-12	Accounting for Physical Commodity Inventories for Entities within the Scope of the AICPA Audit and Accounting Guide, <i>Brokers and Dealers in Securities</i>	8/06	11/06	Not scheduled	Fanzini/ Jacobs	Pending the outcome of the Board's project to amend ARB No. 43, <i>Restatement and Revision of Accounting Research Bulletins</i> .	Future EITF Meeting

<b>Issues Pending Further Consideration by the Agenda Committee</b>							
<b>Issue No.</b>	<b>Description</b>	<b>Date Added</b>	<b>Date(s) Discussed</b>	<b>Next Meeting</b>	<b>FASB Staff</b>	<b>Immediate Plans</b>	<b>Due Date - Next Deliverable</b>
N/A	Application of EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," When a Special-Purpose Entity Holds Equity Securities and Whether an Investment That Is Redeemable at the Option of the Investor Should Be Considered an Equity Security or Debt Security	9/00	N/A	Not scheduled	Jacobs	Statement 155 did not address this Issue. Therefore, the FASB staff will bring this Issue to the Agenda Committee at a future meeting to determine whether to begin discussions on this Issue.	Future Agenda Committee