

**Emerging Issues Task Force  
Agenda Committee Report  
November 2, 2004**

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# 1104REPORT

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

### **1. The Accounting for the Conversion of an Instrument That Becomes Convertible Upon the Issuer's Exercise of a Call Option That Otherwise Is Not Convertible or Not Currently Convertible Based on a Contingency**

#### **Introduction**

At the May 2004 Agenda Committee meeting, the Agenda Committee added an issue to the EITF's Agenda to address certain accounting issues related to contingently convertible debt. Specifically, the Agenda Committee agreed that the Task Force should consider whether shares associated with contingently convertible debt are contingently issuable under FASB Statement No. 128, *Earnings per Share*. At the September 29–30, 2004 EITF meeting, the Task Force reached a consensus on this issue in EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share."

The FASB staff believes that the consensus in Issue 04-8 effectively addresses all of the subissues in the original agenda committee request with the exception of the issuer's accounting for a call option that permits conversion of an instrument even when the market price trigger has not been met (May 26, 2004 Agenda Committee Report, Issue 4a, Subissue 4). Accordingly, the Agenda Committee has been asked to consider whether an issue should be added to the EITF's Agenda to address the issuer's accounting for the conversion of a debt instrument that becomes convertible upon the issuer's exercise of a call option.

#### **Accounting Issue and Alternatives**

The May 2004 Agenda Committee Report introduced this issue in the context of a debt instrument that was contingently convertible based on a market price trigger and whether it is a change in the original conversion terms of the debt if a call option permits conversion of the instrument even when the market price trigger has not been met. If the call option is considered a change in the original conversion privileges, debt extinguishment or induced conversion accounting likely would be required. Although the consensus in Issue 04-8 may have the effect of reducing the number of contingently convertible debt issuances, the practice issue may continue. Further, the underlying issue extends beyond market price triggers to any situation in

which a call option permits conversion of the instrument that was not otherwise convertible or currently convertible based on a contingency other than the passage of time. These call features provide the issuer with the flexibility to settle outstanding debt with cash or equity at the election of the holder. Consider the following two examples:

**Example 1**

An entity issues a debt instrument with a \$1,000 par amount and a maturity date of December 31, 2010. The issuer can call the debt anytime between 2005 and the maturity date of the debt. If the issuer calls the debt, the holder has the option to receive the par amount or a fixed number of shares. If the issuer does not call the debt, the holder does not have a conversion option.

**Example 2**

An entity issues a contingently convertible debt instrument with a market price trigger, a \$1,000 par amount, and a maturity date of December 31, 2010. The debt instrument is convertible at the option of the holder if the share price of the issuer exceeds a specified amount. The issuer can call the debt anytime between 2005 and the maturity date of the debt. If the issuer calls the debt, the holder has the option to receive cash for the par amount or a fixed number of shares, regardless of whether the market price trigger has been met.

Some believe that the exercise of an issuer call option that results in the conversion of such instruments is a conversion pursuant to the privileges provided in the original terms of the instrument and, accordingly, should not result in a gain or loss on conversion. Others believe that the exercise of the call option changes the conversion privileges provided in the original terms of the instrument and, accordingly, should be accounted for as either a debt extinguishment or an induced conversion.

## Accounting Issue and Alternatives

**Issue: The accounting for the conversion of an instrument that becomes convertible upon the issuer's exercise of a call option that otherwise is not convertible or not currently convertible based on a contingency other than the passage of time.**

APB Opinion No. 26, *Early Extinguishment of Debt*, applies to all extinguishments of debt, except (a) troubled debt restructurings, (b) debt that is converted to equity securities of the debtor pursuant to conversion privileges provided in the terms of the debt at issuance, and (c) debt that is converted to equity securities when the conversion privileges are changed to induce conversion of the debt to equity (as described in FASB Statement No. 84, *Induced Conversion of Convertible Debt*).

If the conversion of the debt is pursuant to the conversion privileges provided in the original debt terms, AICPA Accounting Interpretation 1, "Early Extinguishment of Debt," of APB Opinion 26, acknowledges that practice is to credit the carrying amount of the debt to equity upon conversion and no gain or loss is recognized. If the terms of the conversion privileges are changed to induce conversion, Statement 84 requires an entity to recognize an expense equal to the fair value of all securities and other consideration transferred in excess of the fair value of the securities issuable under the original conversion terms. If the conversion of the debt is not pursuant to the conversion privileges provided in the original debt terms and it is not an induced conversion under Statement 84, an entity should account for the conversion as an extinguishment of debt under Opinion 26, which requires an entity to recognize a gain or loss calculated as the difference between the reacquisition price and the carrying amount of the debt.

*View A: The instrument's original terms provide for the possibility that an issuer will exercise its call option and, therefore, the conversion is pursuant to the original terms of the instrument. Accordingly, the conversion of the instrument should be treated in the same manner as the conversion of a noncontingently convertible debt instrument. That is, the carrying amount of the debt should be credited to equity upon conversion and no gain or loss should be recognized.*

*View B: The exercise of the call option changes the conversion privileges of the instrument and provides an inducement for the holder to convert. Accordingly, the conversion should be recognized as an induced conversion under Statement 84.*

*View C: The exercise of the call option changes the conversion privileges of the original instrument. However, the changes in privileges do not meet the requirements of Statement 84 for an induced conversion and, therefore, the conversion should be recognized as a debt extinguishment under Opinion 26.*

**Interaction with Other Board Agenda Projects**

None.

**Agenda Committee Decisions:** *The Agenda Committee agreed to add this Issue to the EITF's agenda.*

## **2. The Accounting for Buy/Sell Transactions of Oil**

Crude oil buy/sell transactions are arrangements in which a company agrees to buy a specific quantity and grade of oil at a specified price to be delivered at a specific location while simultaneously agreeing to sell a specified quantity and grade of oil at a different location with the same counterparty. Companies commonly enter into buy/sell transactions to facilitate (1) the sale of oil that will not be used in its refining operations because of the location of producing wells or the grade of oil, (2) the purchase of the appropriate grade of oil in a location to supply refining operations, or (3) the fulfillment of contractual obligations to deliver oil of a specified grade or at a specific location (or both) in the most cost-efficient manner.

Generally, the buy and sell sides of a buy/sell arrangement are not conditioned on the completion of the other side of the arrangement or the counterparty is permitted to reduce the amount that it delivers if the other party delivers less than the specified quantity. However, in these arrangements, an entity is required to pay the full purchase price for the oil that it receives, the oil is physically delivered and title is passed for each individual transaction. Purchased volumes often do not equal sales volumes. These buy/sell transactions are different from typical oil exchange transactions—specifically, oil exchange transactions typically require the completion of both legs (buy and sell) of the exchange and, after the transactions, the arrangement permits net settlement of the price differential based on quantity, quality, location, and timing of the deliveries (time value).

Companies may enter into multiple, linked buy/sell transactions. For example, assume Company A produces heavy crude oil (dense, viscous crude oil) in California and has refining operations in West Texas that are unable to process heavy crude oil. Company A enters into an arrangement with Company B, which has light, sweet crude oil (low viscosity oil with low sulfur content) production in Oklahoma, but refining operations in California that use heavy oil. Company A agrees to sell Company B a specified quantity of its California production and purchases a similar quantity of Company B's crude oil production in Oklahoma. Company A also enters into an agreement with Company C, which has West Texas crude oil production, but refining operations in Oklahoma. Company A sells the crude oil in Oklahoma purchased from Company

B to Company C, and acquires a similar quantity of West Texas crude oil from Company C for its refining operations.

Currently, diversity in practice exists on how oil and gas companies account for buy/sell transactions. Most integrated companies and some independent refining companies account for all such transactions at fair value, recording both the revenue for the oil sold and inventory/cost of sales for the oil purchased at fair value. Others account for the transactions based on the carrying amount of the crude oil sold consistent with the guidance for nonmonetary exchanges under APB Opinion No. 29, *Accounting for Nonmonetary Transactions*. Still others account for purchases of crude oil for their refineries from buy/sell transactions as nonmonetary exchanges based on the carrying amount of the crude oil sold, but recognize crude oil purchased for resale at fair value.

#### **Accounting Issue and Alternatives**

**The issue is whether oil and gas companies should recognize sales and purchases of oil under buy/sell arrangements at fair value or based on the carrying amount of the inventory sold.**

This issue is limited to buy/sell arrangements for oil that are not accounted for as derivatives under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*—that is, the contracts do not meet the definition of a derivative or the entity has designated the contracts as normal purchases and normal sales pursuant to paragraph 10(b) of Statement 133 and related interpretations. The EITF addressed a similar issue for derivatives in EITF Issue No. 03-11, "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133, and Not 'Held for Trading Purposes' as Defined 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.'" In Issue 03-11, the Task Force reached a consensus that determining whether realized gains and losses on physically settled derivative contracts not "held for trading purposes" should be reported on a gross or net basis is a matter of judgment that depends on the relevant facts and circumstances. Consideration of the facts and circumstances should be made in the context of the various

activities of the entity rather than based solely on the terms of the contract. Additionally, the Task Force acknowledged that the economic substance of the transaction as well as the guidance in Opinion 29 and EITF Issue No. 99-19, "Reporting Revenue Gross as a Principle versus Net as an Agent," may be considered in determining whether the transaction should be reported gross or net.

*View A: All buy/sell transactions should be recognized at fair value.*

Proponents of View A believe that all purchases and sales in a buy/sell arrangement should be accounted for at fair value. These proponents believe that the sale of crude oil is the culmination of an earnings process regardless of the agreement to purchase oil from the same counterparty at a different location and/or grade. That is, they believe that the guidance on the exchange of products in the ordinary course of business in paragraph 21(a) of Opinion 29 is not applicable. Proponents note that a sale of oil that is not linked to a purchase contract must always be recorded at fair value. They believe that a buy/sell arrangement that facilitates the purchase of oil at another location for the purpose of supplying its refinery or fulfilling other contractual obligations, should not affect the accounting for the sale of oil. Further, proponents of View A note that the individual transactions under a buy/sell arrangement include the physical delivery of oil and the associated transfers of title, risk of loss, credit risk, environmental risk, and counterparty non-performance risk.

*View B: All buy/sell arrangements should be recognized at their carrying amount.*

Proponents of View B believe buy/sell arrangements are exchanges of products held for sale in the ordinary course of business and that the earnings process has not culminated. Accordingly, proponents believe that paragraph 21(a) of Opinion 29 requires an entity to record the transactions at their carrying amounts. View B proponents believe that the sale of crude oil should only be recorded at fair value, and reflected as revenue, after it has been sold to the end customer, either as crude oil or a refined product.

*View C: Transactions in a buy/sell arrangement should be recognized based on facts and circumstances.*

View C proponents believe that an entity should consider all of the facts and circumstances of the buy/sell arrangement when determining the appropriate accounting for the purchase and sale transactions. View C proponents note that the consensus in Issue 03-11 supports a facts and circumstances approach and believe that an entity should evaluate each transaction in a manner similar to the guidance in that Issue. Proponents also believe that the only difference between this issue and Issue 03-11 is that Issue 03-11 addresses the income statement presentation for physically settled derivatives, while this Issue only addresses non-derivative instruments. Proponents also note that the "barrel back" example in paragraph 5 of Issue 03-11 is representative of a buy/sell arrangement that is addressed in this Issue.

Some View C proponents believe that the Task Force should provide guidance on how facts and circumstances that are common in buy/sell arrangements for oil should be evaluated in determining the accounting for those transactions.

### **Interaction with Other Board Agenda Projects**

The Board has agreed to amend Opinion 29 in its short-term convergence project; however, the amendment will carry forward the current guidance related to the exchange of products that are held for sale in the ordinary course of business (paragraph 21(a)). Accordingly, the Board's project will not address or provide additional guidance on those transactions. However, if the transactions are not exchanges of products that are held for sale in the ordinary course of business, the amendment to Opinion 29 likely will require an additional evaluation as to whether such transactions have commercial substance.

**Agenda Committee Decisions:** *The Agenda Committee agreed to add this Issue to the EITF's agenda. The Agenda Committee asked the FASB staff to address whether transactions under buy/sell arrangements, as described in this issue, should be considered nonmonetary transactions under Opinion 29 and, if so, whether there are circumstances under which the transactions should be recognized at fair value.*

**FASB EMERGING ISSUES TASK FORCE**  
**November 17–18, 2004 Meeting Agenda**  
**Day 1 – November 17, 2004**

<u>Issue Number</u>	<u>Issue</u>	<u>Proposed Time</u>	<u>Staff Assigned</u>
03-13	Applying the Conditions in Paragraph 42 of FASB Statement No. 144, <i>Accounting for the Impairment or Disposal of Long-Lived Assets</i> , in Determining Whether to Report Discontinued Operations	1:00-2:00	Sogoloff/ Larson
04-6	Accounting for Stripping Costs in the Mining Industry	2:00-3:00	Westerlund/ Larson
	* * * BREAK * * *	3:00-3:15	
04-5	Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights	3:15-5:15	Larson/ Oakley
	* * * Adjourn for Dinner * * *		

**FASB EMERGING ISSUES TASK FORCE**  
**November 17–18, 2004 Meeting Agenda**  
**Day 2 – November 18, 2004**

<b><u>Issue Number</u></b>	<b><u>Issue</u></b>	<b><u>Proposed Time</u></b>	<b><u>Staff Assigned</u></b>
04-7	Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity	8:00-10:15	Laurenzano/ Sogoloff/ Belcher
	* * * BREAK * * *	10:15-10:30	
04-H	Whether Instruments That Are Issued as Stock-Based Compensation Are Participating Securities under FASB Statement No. 128, <i>Earning per Share</i>	10:30-11:30	Oakley/ Larson
	Administrative Matters - New Issues - Other Matters	11:30-12:00	Westerlund
	* * * LUNCH * * *	12:00-1:00	
	Closed Administrative Session	1:00-1:30	Golden
04-F	Accounting in a Business Combination for Deferred Postcontract Customer Support Revenue of a Software Vendor	1:30 – 2:45	Moss/ Thuener
	* * * BREAK * * *	2:45 – 3:00	
<i>TBD</i>	<i>Open for Potential Issue</i>	3:00 – 4:00	

### 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 November 17–18, 2004 meeting are considered either high priority issues or issues on which meaningful progress can be made within the staff's given complement of resources. The staff's prioritization of issues is based primarily on the FASB staff's understanding of the level of diversity in practice created by each respective Issue, the financial reporting implications of that diversity, the current interaction, if any, of the Issues with active Board projects, and current resource availability among the staff (with respect to both time and relevant technical expertise).

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
03-13	Applying the Conditions in Paragraph 42 of FASB Statement No. 144, <i>Accounting for the Impairment or Disposal of Long-Lived Assets</i> , in Determining Whether to Report Discontinued Operations	5/03	11/03, 3/04, 6/04, 9/04	11/04	Sogoloff Larson	FASB staff posted a draft abstract to the FASB website for public comment on October 15, 2004 for a 15-day comment period. The Task Force will consider the comments received at the November meeting.	November meeting materials.
04-5	Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights	5/04	6/04, 9/04	11/04	Larson Oakley	FASB staff to prepare an Issue Summary based on input received from the Task Force at the September meeting.	November meeting materials

<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>
04-6	Accounting for Stripping Costs Incurred during Production in the Mining Industry	11/03	6/04, 9/04	11/04	Westerlund Larson	FASB staff to prepare an Issue Summary that develops additional guidance on the attribution of capitalized stripping costs.	November meeting materials
04-7	Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity	5/04	6/04, 9/04	11/04	Laurenzano Sogoloff Belcher	FASB staff to prepare an Issue Summary with assistance from the Working Group.	November meeting materials
04-F	Accounting in a Business Combination for Deferred Postcontract Customer Support Revenue of a Software Vendor	8/04	N/A	11/04	Moss Thuener	The FASB staff will prepare an Issue Summary for the November 2004 meeting.	November meeting materials
04-H	Whether Instruments That Are Issued as Stock-Based Compensation Are Participating Securities under FASB Statement No. 128, <i>Earning per Share</i>	9/04	N/A	11/04	Oakley Larson	The FASB staff will prepare an Issue Summary for the November 2004 meeting.	November meeting materials

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

**Other EITF Issues including Inactive Issues Pending Developments in Board Projects**

<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>
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	Laurenzano Sogoloff	Pending further progress on Phase II of the Board's liabilities and equity project.	N/A
03-15	Interpretation of Constraining Conditions of a Transferee in a Collateralized Bond Obligation Structure	9/00 (AC) 11/02 (TF)	N/A	Not scheduled	Laurenzano Lusniak	Pending developments in the Board's project on QSPE's and reconsideration by the FASB staff as to the extent of the issue.	N/A

<b>Other EITF Issues including Inactive Issues Pending Developments in Board Projects</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>
03-17	Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity's Balance Sheet	5/03	11/03	Not scheduled	McBride O'Callaghan	Issue addresses the amortization of a recognized executory contract that has periods of both positive and negative cash flows. This issue is pending the Board's consideration of how the factors in paragraph 11(d) of Statement 142 should be evaluated in determining the useful life of an intangible asset (formerly EITF Issue 03-9)	N/A
04-I	The Accounting for Buy/Sell Transactions of Oil	11/04	N/A	Not scheduled	Munro Westerlund	FASB staff to prepare an Issue Summary for a future EITF meeting.	N/A
04-J	The Accounting for the Conversion of an Instrument That Becomes Convertible Upon the Issuer's Exercise of a Call Option That Otherwise Is Not Convertible or Not Currently Convertible Based on a Contingency	11/04	N/A	Not scheduled	Oakley	FASB staff to prepare an Issue Summary for a future EITF Meeting.	N/A

<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	Laurenzano	Pending consideration of an FASB project that may address the measurement of beneficial interests in securitized financial instruments.	Pending developments in a Board project