

0305FN

FINANCIAL ACCOUNTING STANDARDS BOARD

401 Merritt 7, P.O. Box 5116

Norwalk, Connecticut 06856-5116

Telephone: 203-847-0700 Fax: 203-849-9714

Internet address: eitif@fasb.org or lbwesterlund@fasb.org

April 4, 2005

TO: MEMBERS OF THE FASB EMERGING ISSUES TASK FORCE

Included are the final minutes of the March 17, 2005 meeting of the FASB Emerging Issues Task Force and an inventory of open issues for the next EITF meeting. Also included is a confidential version of the minutes that has been marked for changes from the March 31 draft. After your review, please discard the confidential marked version of the minutes.

June Meeting Time and Location

The next EITF meeting will be held on **June 15–16, 2005**, at the FASB offices in Norwalk, Connecticut. Based on our preliminary thoughts on the agenda, the meeting will start at **1:00 p.m.** on June 15 and conclude no later than **4:00 p.m.** on June 16.

Minutes

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

Draft minutes available	June 21, 2005
Final minutes available	July 6, 2005

Agenda Committee Meeting

The next Agenda Committee meeting will be scheduled for sometime in late April or early May 2005. Please provide materials for any potential new issues at your earliest convenience.

Please call me at extension x212 if you have any questions.

Sincerely,

Landon B. Westerlund
Practice Fellow

0305FN

**MINUTES OF THE MARCH 17, 2005 MEETING
OF THE FASB EMERGING ISSUES TASK FORCE**

Location: FASB Offices
401 Merritt 7
Norwalk, Connecticut

Thursday, March 17, 2005

Starting Time: 8:00 a.m.

Concluding Time: 2:45 p.m.

Task Force Members Present:

Lawrence W. Smith (Chairman)

Mark M. Bielstein¹

Frank H. Brod

Jack T. Ciesielski

Mitchell A. Danaher

Leland E. Graul

Joseph F. Graziano

Stuart H. Harden

David L. Holman

James A. Johnson

David B. Kaplan

Louis W. Matusiak, Jr.

Ashwinpaul C. (Tony) Sondhi

Richard H. Stock

Lawrence E. Weinstock

Scott A. Taub (SEC Observer)

Task Force Members Absent:

None

¹ Mr. Bielstein also served as the AcSEC Observer.

Others at Meeting Table:

Robert H. Herz, FASB Board Member
George J. Batavick, FASB Board Member
G. Michael Crooch, FASB Board Member
Leslie F. Seidman, FASB Board Member
Edward W. Trott, FASB Board Member
Donald M. Young, FASB Board Member
Russell G. Golden, FASB Senior Technical Advisor
Landon B. Westerlund, FASB Practice Fellow
Jan R. Hauser, PricewaterhouseCoopers LLP
John James, SEC Professional Accounting Fellow
Marilyn Thaemert, SEC Assistant Chief Accountant
* Richard Graff, Mining Industry Working Group Representative²
* Steven P. Belcher, FASB Practice Fellow
* James W. Geary, FASB Practice Fellow
* Christopher J. Larson, FASB Practice Fellow
* Paul G. Laurenzano, FASB Practice Fellow
* Reginald D. Oakley, FASB Practice Fellow
* Gerard M. O'Callaghan, FASB Practice Fellow
* Randall S. Sogoloff, FASB Practice Fellow

* For certain issues only.

² Invited to discuss with the Task Force issues relating to EITF Issue No. 04-6, "Accounting for Stripping Costs Incurred during Production in the Mining Industry."

ADMINISTRATIVE MATTERS

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

- The Task Force discussed the report on the EITF Agenda Committee meeting held on February 1, 2005. The following decisions were made by the Agenda Committee:
 - a. *Accounting for Minimum Revenue Guarantees.* The Agenda Committee decided not to add this issue to the EITF's agenda. The Agenda Committee asked the FASB staff to consider providing guidance on this issue through the issuance of an FASB Staff Position.
 - b. *Accounting for Altersteilzeit Early Retirement Programs.* The Agenda Committee agreed to add this Issue to the EITF's agenda. The Agenda Committee asked the FASB staff to explore whether other early retirement programs have similar terms and to expand the scope of this Issue accordingly. Additionally, the Agenda Committee directed the FASB staff to expand the Issue to address the accounting for the salary component of the program, any subsidy received from the government, and the effect on the service credit for existing retirement plans.
 - c. *The Effect of Registration Rights with Liquidated Damages Provisions for Financial Instruments Subject to EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."* The Agenda Committee agreed to add this Issue to the EITF's agenda.
 - d. *The Meaning of "Conventional Convertible Debt Instrument" in EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."* The Agenda Committee agreed to add this Issue to the EITF's agenda.
 - e. *Offsetting of a Right to Receive or an Obligation to Return Cash Collateral with a Net Derivative Position under a Master Netting Arrangement.* No decision was reached. The Agenda Committee directed the FASB staff to research the terms of master netting arrangements with the objective of further developing the issue. The Agenda Committee will reconsider this issue at the next Agenda Committee meeting based on that research.

- The Task Force Chairman announced that Mr. Louis W. Matusiak, Jr., from BKD LLP, and Mr. David B. Kaplan from PricewaterhouseCoopers LLP will be stepping down as members of the EITF. The Task Force Chairman thanked Mr. Matusiak and Mr. Kaplan for their service. The Task Force Chairman also announced that Mr. Kaplan will be replaced by Ms. Jan R. Hauser from PricewaterhouseCoopers LLP beginning with the June 15–16, 2005 EITF meeting. A replacement for Mr. Matusiak has not been named at this time.

- Comment letters on the following Issues were reported as received:
 - a. EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights" (18 comment letters)¹
 - b. EITF Issue No. 04-7, "Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity" (2 comment letters).¹

- June 2005 EITF Meeting: The FASB staff asked Task Force members to anticipate a day and a half EITF meeting to be held on June 15–16, 2005.

¹ Discussion of comment letter(s) occurred during discussion of the related Issue.

DISCUSSION OF AGENDA TECHNICAL ISSUES

Issue No. 04-5

Title: Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights¹

Dates Discussed: June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004; March 17, 2005

References: FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*
FASB Statement No. 5, *Accounting for Contingencies*
FASB Statement No. 57, *Related Party Disclosures*
FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*
FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*
AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements*
APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*
APB Opinion No. 20, *Accounting Changes*
APB Opinion No. 29, *Accounting for Nonmonetary Transactions*
AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*

Introduction

1. For many years, financial statement preparers and auditors have debated how to evaluate whether a partnership should be consolidated by one of its partners. Recent guidance provided in Interpretation 46(R)² regarding kick-out rights in the context of evaluating variable interests and consolidation of variable interest entities has renewed the debate over what considerations are relevant in determining whether the general partner should consolidate a limited partnership. In practice today, the question of whether a partnership should be consolidated by one of its partners is typically addressed by analogizing to the guidance in SOP 78-9, which specifically provides guidance on the accounting for investments in real estate ventures, including investments in corporate joint ventures, general partnerships, limited partnerships, and undivided interests. Very little authoritative guidance exists for purposes of assessing whether a limited partner's rights are *important rights* that, under SOP 78-9, might preclude a general partner from

¹ Formerly entitled, "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."

² Refer to paragraph B20 of Interpretation 46(R).

consolidating a limited partnership. As a result, differing views in practice about what rights constitute important rights have evolved over time.

Issue

2. The issue originally considered by the Task Force was when a sole general partner should consolidate a limited partnership.

Prior EITF Discussion

3. At the June 30–July 1, 2004 EITF meeting, the Task Force discussed the general direction and approach for addressing which rights held by a limited partner(s) would preclude consolidation of a limited partnership by the sole general partner. The Task Force agreed that the framework developed by the Working Group for EITF Issue No. 98-6, "Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Approval or Veto Rights," is an appropriate starting point for this Issue, including the presumption that a sole general partner controls and should consolidate a limited partnership absent certain rights held by the limited partner(s). A Task Force member noted that the scope of this Issue should be limited to those limited partnerships with a single general partner or limited partnerships with multiple general partners only if all the general partners are related parties. The Task Force provided the FASB staff with a general direction for developing this Issue.

4. At the September 29–30, 2004 EITF meeting, the Task Force discussed a proposed framework for addressing when a sole general partner should consolidate a limited partnership but did not reach a consensus. The proposed framework presumed that a sole general partner in a limited partnership controls the limited partnership and, therefore, should include the limited partnership in its consolidated financial statements. The presumption of control can be overcome if the limited partners have (a) the substantive ability to remove the sole general partner or otherwise dissolve the limited partnership or (b) substantive participating rights.

5. The Task Force generally agreed with the presumption of control by the sole general partner and that the presumption could be overcome if the limited partners have the ability to remove the sole general partner or otherwise dissolve the limited partnership. The Task Force also generally agreed that the evaluation of whether the rights to dissolve the partnership or remove the general partner are substantive should be consistent with the guidance in paragraph B20 of Interpretation 46(R).

6. The Task Force also discussed the evaluation of whether participating rights held by the limited partners would overcome the presumption of control by the sole general partner. The Task Force observed that there is an inconsistency between the important rights concept in SOP 78-9 and substantive participating rights 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 Shareholders Have Certain Approval or Veto Rights." The Task Force directed the FASB staff to develop an approach to reconcile this inconsistency and to consider the protective rights concept in Issue 96-16. The Task Force acknowledged that such an approach may require a reconsideration of certain aspects of Issue 96-16 and SOP 78-9. The Task Force also directed the FASB staff to consider whether the nature of a limited partnership should be considered when evaluating

whether a sole general partner should consolidate that entity. The Task Force also asked the FASB staff to consider whether there are substantive differences between corporations and partnerships that warrant different consolidation treatment by a general partner or majority owner with respect to the rights of limited partners or minority owners.

7. At the November 17–18, 2004 EITF meeting, the Task Force reached a tentative conclusion on a framework for addressing when a sole general partner should consolidate a limited partnership. The proposed framework presumes that a sole general partner in a limited partnership controls the limited partnership and, therefore, should include the limited partnership in its consolidated financial statements. The presumption of control is overcome if the limited partners have (a) the substantive ability to remove the sole general partner or otherwise dissolve the limited partnership or (b) substantive participating rights. The Task Force agreed that the substantive participating rights that overcome the presumption of control should be consistent with the substantive participating rights described in Issue 96-16. The Task Force further agreed that the "Factors to Consider" in Issue 96-16, which are used in evaluating participating rights, along with the examples, should also be included in this Issue's proposed framework. The Task Force tentatively agreed to add additional guidance for evaluating whether participating rights that can be exercised by a vote of the limited partners or a vote of the limited partners and the sole general partner are substantive. With that exception, the "Factors to Consider" section of the proposed framework would be consistent with Issue 96-16.

8. The Task Force also reached a tentative conclusion that any consensus, upon ratification by the Board, would be effective for all new limited partnership agreements and for limited partnership agreements that are modified subsequent to the date of ratification, and that the application of one of the two transition methods described in Issue 96-16 would be acceptable for existing limited partnerships.

9. The Task Force asked the FASB staff to post a draft abstract to the FASB website for public comment. Further, the Task Force asked the FASB staff to include in the request for comment accompanying the draft abstract a question that asks constituents if guidance similar to that in the draft abstract should be provided for evaluating whether participating rights that can be exercised by a vote of the minority shareholders are substantive for corporate entities.

10. Further, the Task Force acknowledged that the tentative conclusions reached in this Issue conflict with certain aspects of SOP 78-9. The Task Force generally agreed that the accounting for limited partnership investments by a sole general partner should be consistent for all limited partnerships, irrespective of the industry within which the limited partnership operates. Accordingly, the Task Force requested that the Board consider amending the guidance in SOP 78-9 to be consistent with the tentative conclusions reached in this Issue.

11. At its November 30, 2004 meeting, the Board agreed to propose an amendment to certain provisions of SOP 78-9 in anticipation of an EITF consensus consistent with the tentative conclusions reached at the November EITF meeting. The Board indicated that it will consider the outcome of the Task Force's deliberations and the related comments received from constituents before finalizing an amendment to SOP 78-9.

Current EITF Discussion

12. The draft abstract and the proposed amendment to SOP 78-9 (proposed FSP SOP 78-9-a, "Interaction of AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*, and EITF Issue No. 04-5, 'Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights'") were posted to the FASB website for comment on December 22, 2004, for a 60-day comment period. At the March 17, 2005 EITF meeting, the Task Force considered the comment letters on the draft abstract reflecting the tentative conclusions from the November EITF meeting. Based on its consideration of the comment letters and further discussion, the Task Force reached the following tentative conclusions on a revised framework for addressing when the general partners in a limited partnership control the limited partnership (these tentative conclusions are incorporated into the revised draft abstract in Appendix 04-5A):

- a. The scope of this Issue should be expanded to include all limited partnerships and similar entities, including those that have multiple general partners, and should be limited to the question of whether the general partner, or general partners as a group, controls the limited partnership. The title of this Issue has been changed to reflect the revised scope. The Task Force acknowledged that a limited partnership may be controlled by a group of general partners jointly. The Task Force further acknowledged that when a limited partnership is controlled by a group of general partners, the determination of which, if any, general partner within the group should consolidate is based on an analysis of the relevant facts and circumstances. If a single general partner in a group of general partners does not control the general partnership interests in the limited partnership, the guidance in this Issue need not be applied. The Task Force agreed that guidance on determining which general partner in a group of general partners should consolidate the limited partnership is beyond the scope of this Issue.
- b. The general partner, or the general partners as a group, is presumed to control the limited partnership regardless of the general partners' ownership interest in the limited partnership. The Task Force acknowledged the comment letters that questioned whether including a limited partnership in the consolidated financial statements of a general partner that owns an insignificant interest results in a meaningful financial statement presentation. However, the Task Force observed that financial statement presentation and disclosure alternatives exist that may address that concern, including the option of providing consolidating financial statements or separate classification of the assets and liabilities of the limited partnership(s) on the face of the balance sheet.
- c. Kick-out rights are considered to be substantive if those rights can be exercised by a simple majority (or a lower percentage) of the limited partner voting interests held by parties other than the general partners, entities under common control with the general partners, and other parties acting on behalf of the general partners. The Task Force also concluded that all relevant facts and circumstances should be considered in assessing whether other parties, including, but not limited to, those defined as related parties in Statement 57, may also be acting on behalf of the general partners in exercising their voting rights as limited partners. The Task Force concluded that, for purposes of this Issue, a simple majority is the minimum number of votes necessary to achieve a proportion of the relevant voting interests greater than 50 percent. The Task Force also agreed that the application of the simple majority threshold should be illustrated.

- d. Rights that provide the limited partners with the ability to block acquisitions and dispositions of assets that would be expected to be made in the ordinary course of business are participating rights. In determining whether the right is substantive, judgment must be exercised in assessing whether acquisition and disposition decisions would occur in the ordinary course of business. An analysis of the "Factors to Consider," included in the draft abstract, should be undertaken in applying such judgment to the relevant facts and circumstances. Rights to block or approve acquisitions and dispositions that are not expected to be made in the ordinary course of business are protective rights.

13. The Task Force also directed the FASB staff to consider changes to Issue 96-16 that would conform the guidance in that Issue about whether minority shareholder rights to veto acquisitions and dispositions of assets greater than 20 percent of the fair value of the investee's total assets may be substantive participating rights to the guidance in this Issue. The Task Force directed the FASB staff to seek input from constituents on the impact of the proposed change to Issue 96-16 on current and prior practice. Accordingly, the FASB staff will draft a proposed change to Issue 96-16 and post it to the FASB website for public comment. The Task Force will consider the comments on the proposed change to Issue 96-16, including transition alternatives, in conjunction with its deliberations on reaching a final consensus on Issue 04-5 at the June 15–16, 2005 EITF meeting.

14. The Task Force Chairman indicated that the FASB would postpone any further consideration of proposed FSP SOP 78-9-a until the Task Force reaches a final consensus on this Issue.

Status

15. Further discussion is expected at a future meeting.

Appendix 04-5A

EITF Abstracts (DRAFT¹)

Issue No. 04-5

Title: Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights

Dates Discussed: June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004; March 17, 2005

References: FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*
FASB Statement No. 5, *Accounting for Contingencies*
FASB Statement No. 57, *Related Party Disclosures*
FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*
FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*
AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements*
APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*
APB Opinion No. 20, *Accounting Changes*
APB Opinion No. 29, *Accounting for Nonmonetary Transactions*
AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*

ISSUE

1. For many years, financial statement preparers and auditors have debated how to evaluate whether a partnership is controlled by one of its partners. Recent guidance provided in Interpretation 46(R)² regarding "kick-out" rights in the context of evaluating variable interests

¹ This draft abstract was prepared to facilitate discussion of the guidance on which the Task Force reached its tentative conclusions. It contains all substantive aspects of the tentative conclusions.

² Refer to paragraph B20 of Interpretation 46(R).

and consolidation of variable interest entities has renewed the debate over what considerations are relevant in determining whether the general partners control a limited partnership. In practice today, the question of whether a partnership is controlled by one of its partners is typically addressed by analogizing to the guidance in SOP 78-9, which specifically provides guidance on the accounting for investments in real estate ventures, including investments in corporate joint ventures, general partnerships, limited partnerships, and undivided interests. Very little authoritative guidance exists for purposes of assessing whether a limited partner's rights are *important rights* that, under SOP 78-9, might preclude a general partner from controlling a limited partnership. As a result, differing views in practice about what rights constitute important rights have evolved over time.

2. The issue is when a general partner, or the general partners as a group, controls a limited partnership or similar entity when the limited partners have certain rights.

Scope

3. The scope of this Issue is limited to limited partnerships³ or similar entities (such as limited liability companies that have governing provisions that are the functional equivalent of a limited partnership) that are not variable interest entities under Interpretation 46(R). This Issue does not apply to a general partner that, in accordance with generally accepted accounting principles, carries its investment in the limited partnership at fair value with changes in fair value reported in a statement of operations or financial performance. That is, if an enterprise is required to apply the consolidation guidance included in ARB 51 and Statement 94 to its investment in a limited partnership, it is within the scope of this Issue. This Issue also is not intended to change current guidance in Issue No. 00-1, "Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures," on when it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership.

³ When used throughout this Issue, the term *limited partnerships* shall mean either a limited partnership or a similar entity.

4. The Task Force acknowledged that when a limited partnership has multiple general partners, the determination of which, if any, general partner within the group controls and, therefore, should consolidate the limited partnership is based on an analysis of the relevant facts and circumstances.⁴ If no single general partner in a group of general partners controls the limited partnership, the guidance in this Issue need not be applied. The Task Force agreed that guidance on determining which general partner in a group of general partners should consolidate is beyond the scope of this Issue. However, a Task Force member observed that the concepts in this Issue may be helpful in determining whether a single general partner in a group of general partners controls a limited partnership, particularly in relation to assessing whether the combined rights of the other general partners and the limited partners taken together overcome a conclusion that a single general partner controls a limited partnership.

EITF DISCUSSION

5. The Task Force reached a consensus that the *general partners*⁵ in a limited partnership should determine whether they control a limited partnership based on the application of the framework in paragraphs 6-21.

Presumption of Control

6. The general partners in a limited partnership are presumed to control that limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership.⁶ The assessment of whether the rights of the limited partners⁷ should overcome the presumption of control by the general partners is a matter of judgment that depends on facts and circumstances. If the limited partners have either (a) the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause or (b)

⁴ In situations involving multiple general partners, entities under common control are considered to be a single general partner for purposes of applying the guidance in this Issue.

⁵ The term *general partners* refers to one or more general partners and has this meaning when used in the context of this Issue.

⁶ The Task Force observed that an entity has financial statement and disclosure alternatives that may provide additional useful information. For example, an entity may highlight the effects of consolidating a limited partnership by providing consolidating financial statements or separately classifying the assets and liabilities of the limited partnership(s) on the face of the balance sheet.

⁷ The term *limited partners* refers to one or more limited partners and has this meaning when used in the context of this Issue.

substantive participating rights, the general partners do not control the limited partnership. Further guidance on each of these concepts is provided below.

Do the limited partners have the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause?⁸

7. For purposes of this Issue, the rights underlying the limited partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners are collectively referred to as kick-out rights. Determination of whether the kick-out rights are substantive should be based on a consideration of all relevant facts and circumstances. Substantive kick-out rights must have both of the following characteristics:

- a. The kick-out rights can be exercised by a vote of a simple majority⁹ (or a lower percentage) of the limited partner voting interests held by parties other than the general partners, entities under common control with the general partners or a general partner, and other parties acting on behalf of the general partners or a general partner. The Task Force believes that all relevant facts and circumstances should be considered in assessing whether other parties,

⁸ *Without cause* means that no reason need be given for the dissolution (liquidation) of the limited partnership or removal of the general partners. *With cause* generally restricts the limited partners' ability to dissolve (liquidate) the limited partnership or remove the general partners in situations that include, but that would not be limited to, fraud, illegal acts, gross negligence, and bankruptcy of the general partners.

⁹ To illustrate the application of the "simple majority" threshold, consider the following examples: (1) Assume that a limited partnership has three limited partners, none of which have any relationship to the general partners, that each holds an equal amount of the limited partner voting interests (33.33 percent). In this case, applying the simple majority requirement in the partnership agreement would require a vote of no more than two of the three limited partners to remove the general partners. Accordingly, a provision that entitles any individual limited partner to remove the general partner or a provision that requires a vote of two of the limited partners to remove the general partner would meet the requirements of paragraph 7(a) for a substantive kick-out right. However, if a vote of all three limited partners is required to remove the general partner, the right would not meet the requirements of paragraph 7(a) for a substantive kick-out right, because the required vote is greater than a simple majority. (2) Consider the same facts as in Example 1, except that there are two limited partners that each holds an equal interest. In this case, a "simple majority" would be a vote of both limited partners, so a provision entitling any individual limited partner to remove the general partner or a provision that requires a vote of both limited partners to remove the general partner would meet the requirements of paragraph 7(a) for a substantive kick-out right. (3) Consider the same facts as in Example 1, except that there are 100 limited partners that each hold an equal interest. In this case, a "simple majority" would be a vote of 51 limited partners, so a provision that requires a vote of less than 52 limited partners to remove the general partner would meet the requirements of paragraph 7(a) for a substantive kick-out right. However, if a vote of 52 or more limited partners is required to remove the general partner, that provision would not meet the requirements of paragraph 7(a) for a substantive kick-out right because the required vote is greater than a simple majority.

including, but not limited to, those defined as related parties in Statement 57, may be acting on behalf of the general partners in exercising their voting rights as limited partners.

- b. The limited partners holding the kick-out rights have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights. Barriers include, but are not limited to:
- (1) Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise
 - (2) Financial penalties or operational barriers associated with dissolving (liquidating) the limited partnership or replacing the general partners that would act as a significant disincentive for dissolution (liquidation) or removal
 - (3) The absence of an adequate number of qualified replacement general partners or the lack of adequate compensation to attract a qualified replacement
 - (4) The absence of an explicit, reasonable mechanism in the limited partnership agreement or in the applicable laws or regulations, by which the limited partners holding the rights can call for and conduct a vote to exercise those rights
 - (5) The inability of the limited partners holding the rights to obtain the information necessary to exercise them.

8. For purposes of applying paragraph 7, the limited partners' unilateral right to withdraw from the partnership in whole or in part (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership would not overcome the presumption that the general partners control the limited partnership (that is, the withdrawal right is not deemed to be a kick-out right). The requirement to dissolve or liquidate the entire limited partnership upon the withdrawal of a limited partner or partners is not required to be contractual for a withdrawal right to be considered as a potential kick-out right. That is, if a limited partnership is economically compelled to dissolve or liquidate upon the withdrawal of a limited partner, the withdrawal right is considered to be a potential kick-out right.

9. If, based on the preceding evaluation, the limited partners possess substantive kick-out rights, presumption of control by the general partners would be overcome and each of the general

partners would account for its investment in the limited partnership using the equity method of accounting.

Do the limited partners have substantive participating rights?

10. If the limited partners have substantive participating rights, the presumption of control by the general partners would be overcome and each of the general partners would account for its investment in the limited partnership using the equity method of accounting. Substantive participating rights provide the limited partners with the ability to effectively participate in significant decisions that would be expected to be made in the ordinary course of the limited partnership's business.

11. The Task Force agreed that "participating rights" are different from "protective rights." All limited partners' rights could be described as "protective rights," but some rights also allow the limited partners to participate in certain financial and operating decisions of the limited partnership that are made in the ordinary course of business (referred to as participating rights). The Task Force agreed that limited partners' rights that are only protective in nature (referred to as "protective rights") do not overcome the presumption that the general partners control the limited partnership. The Task Force agreed that limited partners' rights, individually or in the aggregate, that provide the limited partners with the right to effectively participate in significant decisions that would be expected to be made in the ordinary course of the limited partnership's business while being protective of the limited partners' investment overcome the presumption that the general partners control the limited partnership.

12. For purposes of applying this framework, decisions made in the ordinary course of business are defined as decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out the limited partnership's current business activities, regardless of whether the events or transactions that would necessitate such decisions are expected to occur in the near term. However, it must be at least reasonably possible that those events or transactions that would necessitate such decisions will occur. Ordinary course of business does not include self-dealing transactions with the general partners.

13. The Task Force reached a consensus that the following guidance should be considered in evaluating whether rights held by the limited partners overcome the presumption of control by the general partners.

Protective Rights

14. The Task Force believes that limited partners' rights (whether granted by contract or by law) that would allow the limited partners to block the following limited partnership actions would be considered protective rights and would not overcome the presumption of control by the general partners.

- a. Amendments to the limited partnership agreement.
- b. Pricing on transactions between the general partners and the limited partnership and related self-dealing transactions.
- c. Liquidation of the limited partnership initiated by the general partners or a decision to cause the limited partnership to enter bankruptcy or other receivership.
- d. Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business. (Limited partners' rights relating to acquisitions and dispositions that are expected to be made in the ordinary course of the limited partnership's business are participating rights. Determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances—see "Factors to Consider" and Exhibit 04-5A.)
- e. Issuance or repurchase of limited partnership interests.

15. The Task Force considered the above to be illustrative of some, but not all, of the protective rights that often are provided to limited partners.

Substantive Participating Rights

16. The Task Force believes that limited partners' rights (whether granted by contract or by law) that would allow limited partners to effectively participate in the following actions of the limited partnership should be considered substantive participating rights and would overcome the presumption that the general partners control the limited partnership:

- a. Selecting, terminating,¹⁰ *and* setting the compensation of management responsible for implementing the limited partnership's policies and procedures
- b. Establishing operating *and* capital decisions of the limited partnership, including budgets, in the ordinary course of business.

17. The Task Force believes that in evaluating the limited partners' rights to determine whether they are substantive, "participation" means the ability of the limited partners to approve or block actions proposed by the general partners. That is, the general partners must have the limited partners' agreement to take the actions outlined above in order for the rights to be substantive participating rights. Participation does not require the ability of the limited partners to initiate actions.

18. The Task Force considered the rights described in paragraph 16 to be illustrative of substantive participating rights, but not necessarily an all-inclusive list. The Task Force believes that the rights noted above are participating rights because, in the aggregate, the rights allow the limited partners to effectively participate in the decisions that occur as part of the ordinary course of the limited partnership's business and are significant factors in directing and carrying out the activities of the limited partnership. Individual rights, such as the right to veto the termination of management responsible for implementing the limited partnership's policies and procedures (if management is outsourced—via contract with a third party—by the general partners), should be assessed based on the facts and circumstances to determine if they are substantive participating rights in and of themselves. However, limited partners' rights that appear to be participating rights but that by themselves are not substantive (see "Factors to Consider" and Exhibit 04-5A) would not overcome the presumption of control by the general partners in the limited partnership. The likelihood that the veto right will be exercised by the limited partners should not be considered when assessing whether a limited partner right is a substantive participating right.

¹⁰ Rights held by the limited partners to remove the general partners from the partnership should be evaluated as kick-out rights pursuant to paragraph 7 of this Issue. Rights of the limited partners to participate in the termination of management (for example, management is outsourced to a party other than the general partner) or the individual members of management of the limited partnership may be substantive participating rights.

Factors to Consider

19. The Task Force agreed that the following factors should be considered in evaluating whether limited partners' rights that appear to be participating are substantive rights—that is, whether these factors provide for effective participation in significant decisions related to the limited partnership's ordinary course of business:

- a. The limited partnership agreement needs to be considered to determine at what level decisions are made—by the general partners or by the limited partnership as a whole—and the rights at each level also should be considered. In all situations, any matters that can be put to a vote of the limited partnership must be considered to determine if the limited partners, individually or in the aggregate, have substantive participating rights by virtue of their ability to vote on matters submitted to a vote of the limited partnership. Determination of whether matters that can be put to a vote of the limited partners, or the vote of the limited partnership as a whole, are substantive should be based on a consideration of all relevant facts and circumstances.
- b. Relationships between the general partners and the limited partners (other than investment in the common limited partnership) that are of a related-party nature, as defined in Statement 57, should be considered in determining if the participating rights of the limited partners are substantive. For example, if the limited partner in a limited partnership is a member of the immediate family of the general partners of the limited partnership, then the rights of the limited partner likely would not overcome the presumption of control by the general partners.
- c. Certain limited partners' rights may deal with operating or capital decisions that are not significant to the ordinary course of business of the limited partnership. The Task Force concluded that limited partners' rights related to items that are not considered significant for directing and carrying out the activities of the limited partnership's business are not substantive participating rights and would not overcome the presumption of control by the general partners. Examples of such limited partners' rights relate to decisions about location

of the limited partnership's headquarters, name of the limited partnership, selection of auditors, and selection of accounting principles for purposes of separate reporting of the limited partnership's operations.

- d. Certain limited partners' rights may provide for the limited partners to participate in significant decisions that would be expected to be made in certain business activities in the "ordinary course of business"; however, the Task Force concluded that the existence of such limited partners' rights should not overcome the presumption that the general partners have control if it is remote¹¹ that the event or transaction that requires the limited partners' approval will occur.

- e. General partners who have a contractual right to buy out the interest of the limited partners in the limited partnership for fair value or less should consider the feasibility of exercising that contractual right when determining if the participating rights of the limited partners are substantive. If such a buyout is prudent, feasible, and substantially within the control of the general partners, the general partners' contractual right to buy out the limited partners demonstrates that the participating right of the limited partners is not a substantive right. The existence of such call options, for purposes of this Issue, negate the participating rights of the limited partners to approve or veto an action of the general partners rather than create an additional ownership interest for the general partners. It would not be "prudent, feasible, and substantially within the control of the general partners" to buy out the limited partners if, for example, (a) the limited partners control technology that is critical to the limited partnership or (b) the limited partners are the principal source of funding for the limited partnership.

20. The examples in Exhibit 04-5A are presented to illustrate how to assess individual limited partners' rights under the consensus in this Issue.

¹¹ *Remote* is defined in Statement 5 as "the chance of the future event or events occurring is slight."

Initial Assessment and Reassessment of Limited Partners' Rights

21. The assessment of limited partners' rights and their impact on the presumption of control of the limited partnership by the general partners should be made when an investor(s) becomes a general partner(s) and should be reassessed if (a) there is a change to the terms or in the exercisability of the rights of the limited partners or general partners, (b) the general partners increase or decrease their ownership of limited partnership interests, or (c) there is an increase or decrease in the number of outstanding limited partnership interests.

Transition

22. The Task Force reached a consensus that for general partners of all new limited partnerships formed and for existing limited partnerships for which the partnership agreements are modified, the guidance in this Issue is effective after [the date of Board ratification – June 29, 2005]. The Task Force also reached a consensus that for general partners in all other limited partnerships, the guidance in this Issue is effective no later than the beginning of the first reporting period in fiscal years beginning after December 15, 2005, and that application of either Transition Method A or Transition Method B, described below, would be acceptable.

Transition Method A

23. For existing limited partnership agreements that have not been modified, the guidance should be applied in financial statements issued for the first reporting period in fiscal years beginning after December 15, 2005. Earlier application is encouraged. Thus, for a public company with a fiscal year ending on December 31, the guidance must be applied no later than the beginning of the first quarter of 2006, based on agreements in effect at the time of adoption. For a company with a fiscal year ending on December 31 that does not issue interim financial statements, the guidance must be applied in the annual statements as of the beginning of the year ended December 31, 2006. If earlier application is chosen and the guidance is applied during an interim period other than the first interim period of the year of change, an entity should apply the guidance in Statement 3.

24. The effect of initially applying this guidance for existing limited partnership agreements should be accounted for similar to a change in accounting principle in accordance with

paragraphs 19(a)–(c) of Opinion 20. Thus, financial statements for prior years should be presented as previously reported, and the cumulative effect, if any, of adopting the guidance on the amount of retained earnings at the beginning of the period in which this guidance is first applied should be included in the net income of the period of the change. The effect on the opening balance sheet of adopting the new accounting principle should be disclosed in the year of adoption. Disclosure of the pro forma effects of application on net income is not required.

25. Generally, a change in accounting for a general partner's interest in a limited partnership from the equity method of accounting to consolidation or a change from consolidation to the equity method would not result in an adjustment to previously reported equity or net income. However, a change from the equity method to consolidation could result in a cumulative effect adjustment if losses that would not have been recognized under the equity method are required to be recognized in consolidation or vice versa (see paragraph 15 of ARB 51, and paragraph 19(i) of Opinion 18). Other items that would have been accounted for differently in prior financial statements if this guidance had been applied *should not be adjusted*.¹²

Transition Method B

26. Alternatively, for existing limited partnership agreements that have not been modified, this guidance may be applied by restating the financial statements of prior periods in accordance with the provisions of Opinion 20. If an entity applies this guidance retrospectively, it should apply it to all existing limited partnership agreements based on the facts and circumstances at the time each investment was made and it should consider changes made in later periods. Other items that would have been accounted for differently in prior financial statements if this guidance had been applied *should be adjusted* in the financial statements under Transition Method B. Under Transition Method B, retrospective application is not required for investments in limited partnerships for which the entity is no longer a general partner as of the date that the guidance in this consensus is adopted.

¹² For example, an exchange of securities accounted for based on recorded amounts, under the presumption that control had not been obtained (pursuant to paragraph 21 of Opinion 29, and Issue No. 01-2, "Interpretations of APB Opinion No. 29"), would not be adjusted to reflect the original exchange as a business combination even if application of the guidance in this Issue suggests that one party had obtained control. In addition, previously recorded intercompany profit elimination entries would not be revised to reflect the impact had an investment been consolidated rather than accounted for under the equity method or vice versa.

Board Ratification

27. At its [June 29, 2005] meeting, the Board ratified the consensus reached by the Task Force in this Issue.

STATUS

28. No further EITF discussion is planned.

Exhibit 04-5A

EXAMPLES OF HOW TO ASSESS INDIVIDUAL LIMITED PARTNERS' RIGHTS UNDER ISSUE 04-5

The Task Force agreed that the following examples would facilitate the understanding of how to assess whether the rights of the limited partners should be considered protective or participating and, if participating, whether the rights are substantive. Although these examples illustrate the possible assessments of individual limited partners' rights, the evaluation of limited partners' rights should consider all of the factors identified in "Factors to Consider" to determine whether the limited partners' rights, individually or in the aggregate, provide for the limited partners to effectively participate in significant decisions that would be expected to be made in the "ordinary course of business."

Example 1

The rights of the limited partners relating to the approval of acquisitions and dispositions of assets that are expected to be undertaken in the ordinary course of business may be substantive participating rights. Rights related only to acquisitions that are not expected to be undertaken in the ordinary course of business usually are protective and would not overcome the presumption of control by the general partners in the limited partnership. Whether the right to approve the acquisition or disposition of assets is "in the ordinary course of business" should be based on an evaluation of the relevant facts and circumstances. In addition, if approval by the limited partners is necessary to incur additional indebtedness to finance an acquisition that is not in the limited partnership's ordinary course of business, then the approval by the limited partners would be considered a protective right.

Example 2

Existing facts and circumstances should be considered in assessing whether the rights of the limited partners relating to a limited partnership incurring additional indebtedness are protective or participating rights. For example, if it is reasonably possible or probable that the limited partnership will need to incur the level of borrowing that requires limited partner approval in its ordinary course of business, the rights of the limited partners would be viewed as substantive participating rights.

Example 3

The rights of the limited partners relating to dividends or other distributions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, rights to block customary or expected dividends or other distributions may be substantive participating rights, while rights to block extraordinary distributions would be protective rights.

Example 4

The rights of the limited partners relating to a limited partnership's specific action (for example, to lease property) in an existing business may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if the limited partnership had the ability to purchase, rather than lease, the property without requiring the approval of the limited partners, then the rights of the limited partners to block the limited partnership from entering into a lease would not be substantive.

Example 5

The rights of the limited partners relating to a limited partnership's negotiation of collective-bargaining agreements with unions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if a limited partnership does not have a collective-bargaining agreement with a union or if the union does not represent a substantial portion of the limited partnership's work force, then the rights of the limited partners to approve or veto a new or broader collective-bargaining agreement are not substantive.

Example 6

Provisions that govern what will occur if the limited partners block the action of the general partners need to be considered to determine whether the rights of the limited partners to block have substance. For example, if (a) the limited partnership agreement provides that if the limited partners block the approval of an operating budget, then the budget simply defaults to last year's budget adjusted for inflation and (b) the limited partnership operates in a mature business for which year-to-year operating budgets would not be expected to vary significantly, then the rights of the limited partners to block the approval of the operating budget do not allow the limited partners to effectively participate and are not substantive.

Example 7

Limited partners' rights relating to the initiation or resolution of a lawsuit may be considered protective or participating depending on the available facts and circumstances. For example, if lawsuits are a part of, or are expected to be a part of, the limited partnership's ordinary course of business, as is the case for some insurance entities, then the limited partners' rights may be considered substantive participating rights.

Example 8

The limited partners have the right to veto the annual operating budget for the first X years of the limited partnership. Based on the facts and circumstances, during the first X years of the limited partnership this right may be a substantive participating right. However, following Year X there is a significant change in the exercisability of the limited partners' right (for example, the veto right terminates). As of the beginning of the period following Year X, since that right no longer exists, the presumption that the general partners control the partnership would not be overcome.

Issue No. 04-6

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

Dates Discussed: June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004; March 17, 2005

References: FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*
FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*
FASB Concepts Statement No. 6, *Elements of Financial Statements*
AICPA Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 4, "Inventory Pricing"
APB Opinion No. 20, *Accounting Changes*
Securities Act Industry Guide 7, *Description of Property by Issuers Engaged or to Be Engaged in Significant Mining Operations*
International Accounting Standards Committee, *An Issues Paper Issued for Comment by the IASC Steering Committee on Extractive Industries*

Introduction

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

Scope

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

3. This Issue applies to stripping costs incurred in the production phase of a mine. Stripping costs are costs incurred for the removal of overburden or waste materials for the purpose of obtaining access to an ore body that will be commercially produced. The accounting for stripping costs incurred before the production phase is not addressed.

Definition of the Production Phase

4. For purposes of this Issue, the definition of the production phase of a mine is as follows:

The production phase of a mine is deemed to have begun when saleable minerals are extracted (produced), regardless of the level of production or revenues.

Issue

5. The issue is how stripping costs incurred during the production phase of a mine in the mining industry should be accounted for.

Prior EITF Discussion

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

7. At the September 29–30, 2004 EITF meeting, the Task Force discussed the accounting for stripping costs incurred during production but did not reach a consensus. The Task Force considered the recommendation of the Working Group that stripping costs incurred during production are a mine development cost that should be capitalized as an investment in the mine and attributed to the proven and probable reserves benefited in a systematic and rational manner. A majority of the Task Force members expressed support for the Working Group recommendation; however, the Task Force directed the FASB staff to develop additional guidance about what constitutes a systematic and rational manner of attributing the capitalized costs to proven and probable reserves benefited. Additionally, the Task Force generally agreed that the attribution of stripping costs incurred in the pre-production phase of the mine should be the same as those incurred during the production phase. Accordingly, the scope of this Issue was expanded to address the accounting for all stripping costs in the mining industry—both pre-production and production stripping costs.

8. At the November 17–18, 2004 EITF meeting, the Task Force generally agreed that stripping costs are mine development costs that should be capitalized as an investment in the mine to the extent that the stripping costs are expected to provide additional future benefit. Additionally, capitalized stripping costs should be attributed to proved and probable reserves in a systematic and rational manner.

9. The Task Force also generally agreed that an enterprise should specifically attribute stripping costs to reserves that directly benefit from the stripping activities. That is, if the reserves in the mine are sufficiently distinct from one another (for example, the mine has multiple ore bodies) such that stripping activities benefit the distinct reserves, the enterprise should attribute the related capitalized stripping costs to the specific reserves benefited. The Task Force generally agreed that both the units-of-production method and a proportional performance ratio (such as a stripping ratio) may be systematic and rational methods to attribute

capitalized costs to reserves benefited. However, in no circumstances should an entity recognize a liability (or accumulated amortization in excess of cumulative capitalized stripping costs) that results from the application of a proportional performance ratio. The Task Force also generally agreed that estimates used to apply those methods should be reevaluated at least on an annual basis or more frequently if there are changes in facts and circumstances. The Task Force also observed that amortization of stripping costs should be included in the cost of inventory when the costs are attributed to reserves that are extracted.

10. The Task Force asked the FASB staff to further explore whether there are factors that an entity should consider when determining the appropriate attribution method and to determine whether the attribution method should be an accounting policy decision or based on the facts and circumstances associated with the mine.

11. The SEC Observer expressed concern over the absence of specific guidance associated with the capitalization of stripping costs as mine development costs and the related attribution of those costs to inventory. However, the SEC Observer agreed to consult further with the SEC staff before concluding on the Issue.

Current EITF Discussion

12. Based on the Task Force's preliminary decisions reached at the November 17–18, 2004 EITF meeting, the FASB staff and the Working Group made an effort to develop a model that would address the concerns of the Task Force and the SEC Observer. Despite that effort, concerns about the preliminary decisions still exist. Accordingly, the Task Force was asked to reconsider its preliminary decisions on the accounting for stripping costs at the March 17, 2005 EITF meeting.

13. At the March 17, 2005 EITF meeting, the Task Force reached a consensus that stripping costs incurred during the production phase of a mine are variable production costs that should be included in the costs of the inventory produced during the period that the stripping costs are incurred. The Task Force noted that the consensus does not address the accounting for stripping costs incurred during the pre-production phase of a mine.

14. The consensus in this Issue is effective for the first reporting period in fiscal years beginning after December 15, 2005, with early adoption permitted. The effect of initially applying this consensus should be accounted for in a manner similar to a cumulative-effect adjustment as described in paragraphs 19(a)–(c) of Opinion 20. Disclosure of the pro forma effects on net income is not required. Entities that elect to early adopt this consensus in an interim period shall report the effects of this change in interim financial statements in accordance with Statement 3. Alternatively, an entity may recognize this change in accounting by restating its prior-period financial statements through retrospective application of this consensus.

Board Ratification

15. At its March 30, 2005 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

Status

16. No further EITF discussion is planned.

Issue No. 04-7

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

Dates Discussed: June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004; March 17, 2005

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

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

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

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

Introduction

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

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

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

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

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

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

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

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

should be addressed separately from the issue of what variability should be considered when making that determination.

Issues

7. The issues are:

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

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

Prior EITF Discussion

8. At the June 30–July 1, 2004 EITF meeting, the Task Force discussed the four potential approaches described in paragraph 5 and some of the attributes inherent in those approaches. During the discussion, a fifth approach that incorporates the attributes of the combination approach and the by-design approach was introduced. The Task Force was not asked to reach a consensus on Issue 1. The Task Force asked the FASB staff and the FASB Interpretation 46(R) Implementation Issues Resource Group (the FIN 46(R) Resource Group) to further develop the fifth approach and to include examples for each of the five potential approaches for discussion at a future meeting.

9. At the September 29–30, 2004 EITF meeting, the FASB staff presented an approach developed by the FASB staff and the FIN 46(R) Resource Group that would first require the determination of the type of variability that needs to be considered: (a) the fair value variability, (b) the cash flow variability, or (c) both the fair value variability and the cash flow variability. The FASB staff observed that although an interest may be absorbing the variability of a variable interest entity using any of the three approaches, many enterprises do not consider such interests to be variable interests because the interest was not designed to absorb the variability of the variable interest entity or the interest creates an amount of variability that offsets the amount of variability absorbed. The FASB staff and the FIN 46(R) Resource Group had identified that issue as an issue that should be addressed when determining whether an interest is a variable interest. As a result, the FASB staff recharacterized the issues to be addressed as follows:

Issue 1(a)— The variability that should be considered when determining whether an interest is a variable interest

Issue 1(b)— The interests that absorb variability of the variable interest entity that should be considered variable interests of the variable interest entity.

10. The Task Force discussed the appropriate variability to be considered in Issue 1(a). Task Force members acknowledged that fair value variability and cash flow variability can both be important when determining whether an interest is a variable interest, but the Task Force raised conceptual and operational concerns about the use of a combined approach. The Task Force

introduced a new approach to address Issue 1(a) that would require the identification of the predominant variability of the entity in determining whether either fair value variability or cash flow variability should be used to determine whether interests are variable interests in the entity. When evaluating the predominant variability of the entity, the Task Force observed that an investor should consider, among other factors, the variability that the entity was designed to be exposed to. The Task Force directed the FASB staff to further develop this new approach and to include examples illustrating the application of this approach, as well as the fair value and cash flow approaches.

11. The Task Force did not specifically discuss Issue 1(b) at the September 29–30, 2004 EITF meeting.

12. At the November 17–18, 2004 EITF meeting, the Task Force discussed several alternatives for evaluating the predominant variability of an entity to determine whether the cash flow approach or the fair value approach should be used to determine whether interests are variable interests in the entity. The Task Force generally agreed that when considering whether an interest is a variable interest in a VIE, there should be a presumption that the fair value approach should be used for interests in financial VIEs and the cash flow approach should be used for interests in nonfinancial VIEs. The Task Force observed that this presumption could be overcome based on an analysis of certain characteristics of the VIE that would indicate that the alternative to the presumed approach is more appropriate for that VIE. The Task Force directed the FASB staff and the FIN 46(R) Resource Group to develop (a) the criteria that would overcome the presumption, (b) a definition of a financial VIE, and (c) examples illustrating the application of the approach to financial and nonfinancial VIEs. The Task Force also asked the FASB staff to consider the impact of variability arising from interest rate risk and foreign currency risk on the presumed approach. Further, the Task Force indicated that, depending on the outcome of this approach for evaluating the predominant variability of an entity, it may consider whether it is appropriate to provide an exception to the analysis for interests that both create and absorb the same type and amount of variability.

13. The Task Force agreed to no longer consider the fair value, cash flow, or combined approaches as independent approaches. However, the Task Force agreed to consider the approach discussed in paragraph 12, which will result in the application of the cash flow or fair value approach depending on the predominant variability of the potential VIE.

Current EITF Discussion

14. At the March 17, 2005 EITF meeting, the Task Force discussed the Presumption Approach and the Risk Approach. The Presumption Approach was developed by the FASB staff and the FIN 46(R) Resource Group to address the concerns that were raised by the Task Force at the November EITF meeting. Under the Presumption Approach, it is presumed that the fair value method is used to determine whether an interest is a variable interest only in (a) a potential *financial* variable interest entity that derives its value from the active management of its assets or (b) a potential *nonfinancial* variable interest entity that derives its value from the active management of nonfinancial assets that are readily convertible into cash. For all other entities, use of the cash flow method is presumed to determine whether an interest is a variable interest. The Risk Approach emphasizes the variability that is disproportionately absorbed by the

subordinated interests of a potential VIE. The Task Force discussed the application of each approach and, during that discussion, certain Board members expressed concerns about each approach. The Task Force was not asked to reach a consensus. The Task Force asked the Board to consider providing guidance on the variability that should be considered when determining whether an interest is a variable interest.

Status

15. At its March 30, 2005 meeting, the Board agreed to add a project to provide guidance on the variability that should be considered when determining whether an interest is a variable interest. The FASB staff will ask the Task Force to remove this Issue from its agenda at the June 15–16, 2005 EITF meeting.

Issue No. 04-13

Title: Accounting for Purchases and Sales of Inventory with the Same Counterparty

Dates Discussed: November 17–18, 2004; March 17, 2005

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

FASB Statement No. 153, *Exchanges of Nonmonetary Assets*

Accounting Research Bulletin No. 43, Chapter 4, "Inventory Pricing"

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

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

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

AICPA Technical Practice Aids, Section 5100.46, "Nonmonetary Exchanges of Software (Part 1)"

AICPA Technical Practice Aids, Section 5100.47, "Nonmonetary Exchanges of Software (Part II)"

Introduction

1. An entity may sell inventory to another entity in the same line of business from which it also purchases inventory. The purchase and sale transactions may be pursuant to a single contractual arrangement or separate contractual arrangements, and the inventory purchased or sold may be in the form of raw materials, work-in-process (WIP), or finished goods. The following questions have been raised about the accounting for those types of transactions:

- a. Under what circumstances should two or more transactions with the same counterparty (counterparties) be viewed as a single nonmonetary transaction within the scope of Opinion 29?
- b. If nonmonetary transactions within the scope of Opinion 29 are exchanges of inventory within the same line of business, are there circumstances under which the transactions should be recognized at fair value?

2. The FASB staff asked the Task Force to consider the second question, that is, are there any circumstances under which nonmonetary exchanges of inventory within the same line of

business should be recognized at fair value.¹ The Task Force will be asked to address the first question at a future meeting.

Issue

3. The issue is whether there are circumstances under which nonmonetary exchanges of inventory within the same line of business should be recognized at fair value.

Prior EITF Discussion

4. At the November 17–18, 2004 EITF meeting, the Task Force discussed whether there are circumstances under which nonmonetary exchanges of inventory within the same line of business should be recognized at fair value but did not reach a consensus. The Task Force focused on whether paragraph 21(a) of Opinion 29 was intended to apply to exchanges of all types of inventory (that is, raw materials, work-in-process, and finished goods) or only finished goods inventory. The Task Force requested that the FASB staff further explore alternative views as to whether there are circumstances under which nonmonetary exchanges of inventory should be recognized at fair value, including a view based on whether the transaction has "commercial substance" as defined by Statement 153.

Current EITF Discussion

5. At the March 17, 2005 EITF meeting, the Task Force reached a tentative conclusion that a nonmonetary exchange whereby finished goods inventory is transferred in exchange for the receipt of raw materials or work-in-process (WIP) inventory within the same line of business should be recognized at fair value if (a) fair value is determinable within reasonable limits and (b) the transaction has commercial substance (paragraphs 20 and 21 of Opinion 29, as amended by Statement 153²). All other nonmonetary exchanges of inventory within the same line of business should be recognized at the carrying amount of the inventory transferred. That is, a nonmonetary exchange within the same line of business involving (a) the transfer of raw materials or WIP inventory in exchange for the receipt of raw materials, WIP, or finished goods inventory or (b) the transfer of finished goods inventory for the receipt of finished goods inventory would not be recognized at fair value. The Task Force also reached a tentative conclusion that the classification of a type of inventory for purposes of this Issue should be the same classification that an entity uses for external financial reporting purposes. The Task Force also agreed that an entity should disclose the amount of revenue and costs (or gains/losses) associated with inventory exchanges recognized at fair value. Further, the FASB staff observes that this Issue does not address whether these transactions qualify for revenue recognition.

6. The Task Force requested that the FASB staff further explore circumstances in which two or more inventory transactions with the same counterparty (counterparties) should be viewed as a single nonmonetary transaction within the scope of Opinion 29.

¹ Opinion 29 is applicable to buy/sell arrangements that are not accounted for as derivatives under Statement 133 (for example, because the entity has designated the contracts as normal purchases and normal sales pursuant to paragraph 10(b) of Statement 133 and related interpretations).

² This tentative conclusion assumes that the effective date for a final consensus on this Issue will be after the effective date of Statement 153. Statement 153 amends Opinion 29 to require nonmonetary transactions to be accounted for at fair value unless (a) fair value is not determinable, (b) the exchange transaction is to facilitate sales to customers, which this Issue interprets, or (c) the exchange transaction lacks commercial substance.

Status

7. Further discussion is expected at a future meeting.

Issue No. 05-1

Title: Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option

Date Discussed: March 17, 2005

References: FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*
FASB Statement No. 84, *Induced Conversions of Convertible Debt*
FASB Technical Bulletin No. 80-1, *Early Extinguishment of Debt through Exchange for Common or Preferred Stock*
APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*
APB Opinion No. 26, *Early Extinguishment of Debt*
AICPA Accounting Interpretation 1, *Debt Tendered to Exercise Warrants*, of APB Opinion No. 26

Introduction

1. At the September 29–30, 2004 EITF meeting, a consensus was reached on EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share." The contingently convertible instruments (CoCos) addressed in Issue 04-8 also may contain an embedded issuer call option that permits conversion of an instrument by the holder even when the instrument's market price trigger has not been met. Although this Issue was raised in the context of CoCos with market price triggers, it also extends beyond market price triggers to any situation in which a call option permits conversion of an instrument that is not otherwise convertible or not otherwise currently convertible because of a contingency other than the passage of time. These call options provide the issuer with the ability to call the debt any time (excluding lock-out periods). The holder has the flexibility to receive cash for the call price or equity. The holder typically will choose to receive equity if the conversion ratio is at a premium to the call price of the debt. Therefore, if the issuer prefers to settle the debt in shares, it may call the debt anytime before maturity (including days before maturity) and, if the conversion ratio is at a premium to the call amount of the debt, the instrument holder typically will elect to convert the debt to equity.

2. To illustrate the underlying issue, 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 at par 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 of the debt or a fixed number of shares. If the issuer does not call the debt, the holder does not have a conversion option and will receive cash at maturity.

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, 2020. 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 2009 and the maturity date of the debt. If the issuer calls the debt, the holder has the option to receive cash for the call amount or a fixed number of shares, regardless of whether the market price trigger has been met.

Issue

3. The issue is how to account 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.

Current EITF Discussion

4. At the March 17, 2005 EITF meeting, the Task Force reached a tentative conclusion that no gain or loss should be recognized upon the conversion of an instrument that becomes convertible as a result of an issuer's exercise of a call option pursuant to the original terms of the instrument. The Task Force based its tentative conclusion on the fact that Opinion 26 does not apply to debt that is converted to equity of the issuer based on conversion privileges that were included in the terms of the instrument.

5. The Task Force asked the FASB staff to consider the earnings per share treatment for these instruments before the exercise of the call option and then compare that treatment with the earnings per share treatment for instruments with similar terms. The examples also will illustrate the application of Opinion 26 to these similar instruments. The Task Force will consider those examples at a future meeting.

Status

6. Further discussion is expected at a future meeting.

Status of Open Issues and Agenda Committee Items

The following represents the FASB staff's assessment of the status and immediate plans with respect to the open Issues on the Task Force's agenda. The Issues on the proposed agenda for the June 15–16, 2005 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
04-5	Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights	5/04	6/04, 9/04, 11/04, 3/05	6/05	Larson Oakley	FASB Staff will draft a proposed change to Issue 96-16 and post it to the FASB web site for public comment. Additionally, the staff will prepare an Issue Summary for the June 2005 meeting.	June meeting materials
04-13	Accounting for Purchases and Sales of Inventory with the Same Counterparty	11/04	11/04, 3/05	6/05	Geary Oakley Belcher	The FASB staff will prepare an Issue Summary with the assistance of a working group for the June 2005 meeting.	June meeting materials

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
05-1	Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option	11/04	3/05	6/05	O'Callaghan Oakley	The FASB staff will prepare an Issue Summary for the June 2005 meeting.	June meeting materials
05-A	Accounting for Altersteilzeit Early Retirement Programs	2/05	N/A	6/05	Geary Moss	The FASB staff will prepare an Issue Summary for the June 2005 meeting.	June meeting materials
05-B	The Effect of Registration Rights with Liquidated Damages Provisions for Financial Instruments Subject to EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"	2/05	N/A	6/05	Thuener E. Smith Richards	The FASB staff will prepare an Issue Summary for the June 2005 meeting.	June meeting materials
05-C	The Meaning of "Conventional Convertible Debt Instrument" in EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"	2/05	N/A	6/05	Moss E. Smith Richards	The FASB staff will prepare an Issue Summary for the June 2005 meeting.	June 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	Not assigned	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	Richards	Pending further progress on Phase II of the Board's liabilities and equity project.	N/A

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
02-D	The Effect of Dual-Indexation both to a Company's Own Stock and to Interest Rates and the Company's Credit Risk in Evaluating the Exception under Paragraph 11(a)(1) of FASB Statement No. 133, <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	Lusniak	Pending developments in the Board's project on QSPE's and reconsideration by the FASB staff as to the extent of the issue.	N/A

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
03-17	Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity's Balance Sheet	5/03	11/03	Not scheduled	McBride O'Callaghan	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
04-7	Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity	5/04	6/04, 9/04, 11/04, 3/05	6/05	Laurenzano Sogoloff Belcher	At its March 30, 2005 meeting, the Board agreed to add a project to provide guidance on the variability that should be considered when determining whether an interest is a variable interest. The FASB staff will ask the Task Force to remove this Issue from its agenda.	N/A

Issues Pending Further Consideration by the Agenda Committee							
Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
N/A	Application of EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," When a Special-Purpose Entity Holds Equity Securities and Whether an Investment That Is Redeemable at the Option of the Investor Should Be Considered an Equity Security or Debt Security	9/00	N/A	Not scheduled	Laurenzano	Pending consideration of an FASB project that may address the measurement of beneficial interests in securitized financial instruments.	Pending developments in a Board project
N/A	Offsetting of a Right to Receive or an Obligation to Return Cash Collateral with a Net Derivative Position under a Master Netting Arrangement	N/A	N/A	Not scheduled	Larson	Pending FASB staff research on the terms of master netting arrangements to further develop the issue.	The Agenda Committee will reconsider at its next meeting.