MINUTES OF THE NOVEMBER 12–13, 2003 OPEN MEETING OF THE FASB EMERGING ISSUES TASK FORCE

Location: FASB Offices
401 Merritt 7
Norwalk, Connecticut

Wednesday, November 12, 2003

Starting Time:	10:00 a.m.
Concluding Time:	5:00 p.m.

Thursday, November 13, 2003

Starting Time:	8:00 a.m.
Concluding Time:	2:00 p.m.

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

Task Force Members Absent:
None

Others at Meeting Table:
* Robert H. Herz, FASB Board Member
George J. Batavick, FASB Board Member
G. Michael Crooch, FASB Board Member
Gary S. Schieneman, FASB Board Member
Katherine A. Schipper, FASB Board Member
Leslie F. Seidman, FASB Board Member
Edward W. Trott, FASB Board Member
D. Douglas Alkema, SEC Professional Accounting Fellow
Shelly C. Luisi, SEC Associate Chief Accountant
Patrick G. Durbin, FASB Practice Fellow
* Christopher J. Larson, FASB Practice Fellow
* Paul G. Laurenzano, FASB Practice Fellow
* Kevin T. McBride, FASB Industry Fellow
* Gerard M. O'Callaghan, FASB Practice Fellow
* Matthew H. Pinson, FASB Practice Fellow
* Randall S. Sogoloff, FASB Practice Fellow
* Michael W. Tovey, FASB Practice Fellow
* Landon B. Westerlund, FASB Practice Fellow
* Robert C. Wilkins, FASB Senior Project Manager
* Victoria A. Lusniak, FASB Assistant Project Manager

* For certain issues only.

ADMINISTRATIVE MATTERS

- Prior Meeting Minutes. The Task Force Chairman solicited objections to the final minutes of the July 31, 2003 meeting. No objections were noted.

- Finalization of EITF Issue No. 03-8, "Accounting for Claims-Made Insurance and Retroactive Insurance Contracts by the Insured Entity." The Task Force affirmed the draft abstract for the proposed codification of the guidance contained in EITF Issue No. 86-12, "Accounting by Insureds for Claims-Made Insurance Policies," EITF Issue No. 03-3, "Applicability of *EITF Abstracts*, Topic No. D-79, 'Accounting for Retroactive Insurance Contracts Purchased by Entities Other Than Insurance Enterprises,' to Claims-Made Insurance Policies," and Topic D-79. The codification will be included in the next update of *EITF Abstracts.*

- *EITF Abstracts*, Topic No. D-98, "Classification and Measurement of Redeemable Securities." The SEC Observer announced the SEC staff's position relating to the application of Topic D-98 to certain mandatorily redeemable securities for which the relevant portions of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, were recently deferred in FSP FAS 150-3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150." The SEC Observer clarified that SEC registrants with instruments that qualify for the deferral should refer to Topic D-98 for guidance related to classification and/or measurement, as applicable, for those securities that, for the time being, will not be accounted for in accordance with Statement 150.

- The Task Force discussed the reports on the EITF Agenda Committee meetings held on September 22, 2003 (regular meeting) and November 5, 2003 (supplementary meeting to consider mining industry issues). The following decisions and recommendations were made by the Agenda Committee:

a. Accounting for a Prepaid Written Put Option on an Entity's Own Common Stock. The Agenda Committee decided not to add this issue to the EITF's agenda at this time. The FASB staff does not have a consensus view on this issue and acknowledges that many of the issues raised by this instrument are being considered in Phase 2 of the Board's liabilities and equity project.

b. Impact of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, on EITF Issue No. 95-1, "Revenue Recognition on Sales with a Guaranteed Minimum Resale Value." The Agenda Committee decided to add this Issue to the EITF's agenda and agreed that this Issue should be considered by the Task Force at the November 12–13, 2003 EITF meeting. Refer to the discussion of EITF Issue No. 03-12, "Impact of FASB Interpretation No. 45, *Guarantor's*

Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, on EITF Issue No. 95-1, 'Revenue Recognition on Sales with a Guaranteed Minimum Resale Value,'" elsewhere in these minutes.

c. Accounting for Investments in Limited Liability Companies. The Agenda Committee decided to add this Issue to the EITF's agenda and agreed that this Issue should be considered by the Task Force at the November 12–13, 2003 EITF meeting. The Agenda Committee also recommended that the staff consider the comment letters received by the AICPA in response to AcSEC's exposure draft of a Statement of Position, *Unconsolidated Real Estate Investments*, in formulating the materials for Task Force discussion. Refer to the discussion of EITF Issue No. 03-16, "Accounting for Investments in Limited Liability Companies," elsewhere in these minutes.

d. Disclosure of the Effects of Possible Litigation Arising from Conversion of Traditional Pension Plans to Cash Balance Arrangements. The Agenda Committee decided not to add this issue to the EITF's agenda but agreed with the FASB staff's recommendation that plan sponsors should carefully consider the impact of the recent court decisions in the context of existing authoritative guidance regarding contingencies.

e. Accounting for Preexisting Contracts between the Parties to a Purchase Business Combination. The Agenda Committee decided not to add this issue to the EITF's agenda but recommended that the issue be referred to the Board's project on Business Combinations: Purchase Method Procedures for consideration of implementation guidance that possibly would clarify the accounting for these arrangements.

f. Accounting for the Settlement of Litigation over the Purchase Price of an Acquired Business. The Agenda Committee decided not to add this issue to the EITF's agenda and observed that the appropriate accounting treatment in these circumstances is highly dependent on the specific facts and circumstances of a particular arrangement.

g. Valuation and Impairment Testing of Certain Indefinite-Lived Intangible Assets. The Agenda Committee decided not to add this issue to the EITF's agenda.

h. Whether Mineral Rights Are Tangible or Intangible Assets. The Agenda Committee decided to add this issue to the EITF's agenda. The Agenda Committee agreed with the observation of the Working Group that was created to consider these issues that a decision by the Task Force that all mineral rights are tangible assets would necessitate an amendment to FASB Statement No. 141, *Business Combinations*. The SEC Observer indicated that the SEC would continue to interpret the provisions of Statement 141 and FASB Statement No. 142, *Goodwill and Other Intangible Assets*, with respect to mineral rights as written—that is, as intangible assets—pending an amendment of Statement 141.

i. Mineral Assets: Impairment and Business Combinations. The Agenda Committee decided to add this issue to the EITF's agenda.

j. Allocation of Goodwill to Reporting Units for a Mining Enterprise. The Agenda Committee decided to add this issue to the EITF's agenda.

k. The Accounting for Certain Costs in the Mining Industry, Including Deferred Stripping Costs. The Agenda Committee decided to add this issue to the EITF's agenda. The Agenda Committee recommended that the issue attempt to identify characteristics of costs that should be capitalized because they will provide future benefit rather than prescribing accounting for costs that are commonly referred to in a certain manner.

l. Application of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, to Oil and Gas Companies. The Agenda Committee decided to add this issue to the EITF's agenda but indicated that the conclusions in the issue on whether mineral rights are tangible or intangible assets (see Item (h) above) should be considered in connection with this issue.

m. EITF Issue No. 00-N, "Measuring Fair Value of Equity Securities with Restrictions in a Nonmonetary Exchange." The Agenda Committee recommended that this Issue be removed from the EITF's agenda as the proposed EITF Issue has effectively been resolved by recent Board decisions in the project on the replacement of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*. The Agenda Committee also agreed that the decision to remove this Issue from the EITF's agenda should not be construed as overriding the guidance in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, which continues to be effective for equity securities with restrictions. The Task Force did not object to the Agenda Committee's recommendation.

n. EITF Issue No. 01-J, "Accounting for the Deconsolidation of a Majority-Owned Subsidiary." The Agenda Committee recommended that this Issue be removed from the EITF's agenda as a result of the relative lack of pervasiveness of this Issue, and the difficult accounting boundaries that would necessarily be challenged by any aspect of this Issue. The Task Force did not object to the Agenda Committee's recommendation.

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

a. EITF Issue No. 03-10, "Application of EITF Issue No. 02-16, 'Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor,' by Resellers to Sales Incentives Offered to Consumers by Manufacturers" (5 comment letters)[1]

b. EITF Issue No. 03-11, "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and Not 'Held for Trading Purposes' as Defined in EITF Issue No. 02-3, 'Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities'" (1 comment letter)[2]

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[1] Discussion of comment letters occurred during the discussion of the related Issue.
[2] Issue not on the agenda for the November 12-13, 2003 EITF meeting.

c. EITF Issue No. 03-15, "Interpretation of Constraining Conditions of a Transferee in a CBO Structure" (1 comment letter)[3]

d. EITF Issue No. 03-17, "Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity's Balance Sheet" (1 comment letter).[4]

- The Task Force Chairman announced the meeting schedule for 2004.

a. January 15, 2004. One-day meeting.
b. March 17-18, 2004. One-and-a-half or two-day meeting.
c. June (days to be determined), 2004. One-and-a-half or two-day meeting.
d. September 29-30, 2004. One-and-a-half or two-day meeting.
e. November (day to be determined), 2004. One-day meeting.

- EITF Issue No. 03-15, "Interpretation of Constraining Conditions of a Transferee in a CBO Structure," was on the agenda for the November 12–13, 2003 EITF meeting but was not discussed.

[3] Issue not discussed at the November 12-13, 2003 EITF meeting.
[4] Refer to footnote 1.

REVISION TO THE MINUTES OF THE JULY 31, 2003 MEETING

Issue No. 03-6

Title: Participating Securities and the Two-Class Method under FASB Statement No. 128, *Earnings per Share*

Date Discussed: November 12–13, 2003

An FASB staff member announced that a typographical error was discovered and corrected prior to the publication of this Issue in *EITF Abstracts*. The correction of that error in footnote 3 of the minutes is as follows (the additions are underscored and deletions are scored through):

4. Consider the following example:

> Company ABC has 10,000 shares of common stock and 5,000 shares of convertible preferred stock outstanding. Each share of preferred stock is convertible into one share of common stock. The preferred stock participates in any dividends on a 1:1 per share ratio with common stock. That is, the preferred stock receives dividends at a rate that results in a per share amount that is equivalent to the per share amount paid on common stock. Company ABC had net income of $50,000 for 20X3 and paid no dividends during 20X3. Company ABC has an accounting policy that preferred stock will be included in its computation of basic EPS using the if-converted method as long as the dilutive effect on basic EPS is at least as great as the effect of the two-class method.

Company ABC could not compute basic EPS excluding the convertible participating securities ($5.00 per share[1]), as the effect of the convertible preferred stock is dilutive. Instead, Company ABC would compute basic EPS using the if-converted method ($3.33 per share[2]), as the dilutive effect that would result from including the effect of the convertible preferred stock under the if-converted method is no less than that which would result from the application of the two-class method if the preferred stock were not convertible ($3.33 per share[3]).

[1] *Computation of basic EPS excluding the convertible preferred stock:*

$$\frac{\text{Net income available to common shareholders}}{\text{Outstanding shares}} = \text{Basic EPS}$$

$$\frac{\$50{,}000}{10{,}000 \text{ shares}} = \$5.00 \text{ per share}$$

[2] *Computation of basic EPS using if-converted method:*

$$\frac{\$50{,}000}{15{,}000 \text{ shares}} = \$3.33 \text{ per share}$$

Note: Conversion of the preferred stock results in 15,000 shares of common stock outstanding.

[3] *Computation of basic EPS using two-class method:*

Undistributed 20X3 earnings	=	Net income – Dividends
\$50,000	=	\$50,000 – \$0

Allocation of undistributed earnings:

To common stock:

$$\frac{(10{,}000)}{[(5{,}000) + (10{,}000)]} \times \$50{,}000 = \$33{,}333$$

$$\frac{\$33{,}333}{10{,}000 \text{ shares}} \cancel{= \$33{,}333} = \$3.33 \text{ per share}$$

To preferred stock:

$$\frac{(5{,}000)}{[(5{,}000) + (10{,}000)]} \times \$50{,}000 = \$16{,}667$$

$$\frac{\$16{,}667}{5{,}000 \text{ shares}} = \$3.33 \text{ per share}$$

	Common	Preferred
Distributed earnings	\$0.00	\$0.00
Undistributed earnings	3.33	3.33
Totals	\$3.33	\$3.33

DISCUSSION OF AGENDA TECHNICAL ISSUES

Issue No. 02-14

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

Dates Discussed: September 11–12, 2002; November 21, 2002; January 23, 2003; March 20, 2003; November 12–13, 2003

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

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

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

FASB Statement No. 128, *Earnings per Share*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Introduction

1. In March 1971, the Accounting Principles Board issued Opinion 18 to prescribe accounting standards for common stock investments under the equity method. Paragraph 17 of Opinion 18 states, "… the equity method of accounting for an investment in common stock should also be followed by an investor whose investment in *voting stock* gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock" (emphasis added). Paragraph 2 of Opinion 18 states that "the Opinion also does not apply to investments in common stock other than those described in the Opinion." By inference, the scope of Opinion 18 is restricted to voting common stock. The scope of Opinion 18 was soon questioned, and, in November 1971, the AICPA issued Interpretation 2 of Opinion 18, which reemphasized that "APB Opinion No. 18 applies only to investments in common stock of corporations . . . ."[1]

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

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

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

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

Issues

5. The issue is whether the equity method of accounting applies when an investor does not have an investment in voting common stock of an investee but exercises significant influence through other means.

Prior EITF Discussion

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

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

8. The Task Force also discussed the meaning of other-than-temporary impairment and its application to certain investments carried at cost. The Task Force requested that the FASB staff consider other impairment models within U.S. GAAP when developing its views. The Task Force also requested that the scope of the impairment issue be expanded to include equity method investments and investments subject to Statement 115 and that that issue be addressed by the Task Force as a separate EITF Issue.

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

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

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

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

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

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

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

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

Residual-Interest Category Definition: an ownership interest or a residual interest, or both,[5] that does not obligate,[6] in and of itself or in combination with other financial instruments, the investee to transfer something of value (for example, assets or ownership interests) to the interestholder (or investor) at a nonspecious future date[7] except in the event of the enterprise's liquidation unless the enterprise formally acts to distribute something of value to owners, for example, by declaring a dividend. Common stock, voting and nonvoting, is an economic interest satisfying this definition; it represents both an ownership interest and a residual interest, and it does not obligate the enterprise to transfer something of value to the interest holder at a future date. However, puttable common stock may or may not obligate the enterprise to transfer something of value at a nonspecious future date depending upon the terms of the embedded put option. Preferred stock—voting or nonvoting, participating or nonparticipating, convertible or nonconvertible—is an economic interest that satisfies this definition: it represents both an ownership interest and a residual interest,[8] and it does not obligate the enterprise to transfer something of value to the interestholder.[9] Redeemable preferred stock may or may not obligate the enterprise to transfer something of value at a nonspecious future date; it depends on the facts and circumstances of the arrangement.

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

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

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

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

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

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

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

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

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

Current EITF Discussion

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

16. Some Task Force members observed that other authoritative literature (such as Accounting Interpretation 2 of Opinion 18; SOP 78-9; EITF Issues No. 95-6, "Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation," No. 98-13, "Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee," and No. 99-10, "Percentage Used to Determine the Amount of

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

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

Equity Method Losses"; and *EITF Abstracts*, Topic No. D-46, "Accounting for Limited Partnership Investments") requires the equity method of accounting for investments in instruments other than voting common stock. Those Task Force members also believe that applying the equity method to investments other than voting common stock does not create procedural conflicts for common stock investors. Therefore, the Task Force decided not to remove this Issue from the EITF's agenda but agreed to form a working group to further explore the issues raised by the Task Force for discussion at a future meeting.

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

Status

18. Further discussion is expected at a future meeting.

Issue No. 03-1

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

Dates Discussed: January 23, 2003; March 20, 2003; May 15, 2003; July 31, 2003; November 12–13, 2003

References: FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*

FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*

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

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

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

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

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

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

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

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

AICPA Practice Bulletin No. 6, *Amortization of Discounts on Certain Acquired Loans*

AICPA Accounting and Auditing Guide, *Health Care Organizations*

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

Issue

1. The issue is to determine the meaning of other-than-temporary impairment and its application to investments classified as either available-for-sale or held-to-maturity under Statement 115 (including individual securities and investments in mutual funds), and investments accounted for under the cost method or the equity method.

Prior EITF Discussion

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

3. At the November 21, 2002 EITF meeting, the Task Force discussed the meaning of other-than-temporary impairment and its application to certain investments carried at cost. The Task Force requested that the FASB staff consider other impairment models within U.S. GAAP when developing its views. The Task Force also requested that the scope of the impairment issue be expanded to include equity method investments and investments subject to Statement 115, and that the issue be addressed by the Task Force separately from Issue 02-14.

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

5. At the March 20, 2003 EITF meeting, the Task Force discussed proposed guidance for assessing other-than-temporary impairment that was recommended by the Working Group. That proposed guidance would apply to investments accounted for under the cost method or the equity method, investments classified as either available-for-sale or held-to-maturity under Statement 115 (including individual securities and mutual funds), and investments accounted for under Statement 124. It would not apply to investments within the scope of EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets." The proposed guidance includes the following:

Step 1: Determine whether an investment is impaired
Step 2: Determine whether an impairment is other than temporary
Step 3: Recognize an impairment loss equal to the difference between the investment's carrying amount and its fair value (measured as of the balance sheet date).

6. Step 1 of the proposed guidance generally states that an investment is considered impaired if its fair value is less than its amortized cost basis (hereinafter referred to as its carrying amount).

7. Step 2 of the proposed guidance includes the following underlying principle for determining whether an impairment is other than temporary: an impairment shall be deemed other than temporary unless positive evidence indicating that an investment's carrying amount is recoverable within a reasonable period of time outweighs negative evidence to the contrary.

Under the proposed guidance, the longer the investment's fair value is below its carrying amount, the more unlikely it becomes that sufficient objective and verifiable positive evidence would be available to support the recoverability of the investment's carrying value to overcome the extent of the negative evidence, except for certain investments with noncontingent contractual future cash flows. In attempting to clarify that notion, the model proposed at the March 20, 2003 EITF meeting included a rebuttable presumption that an impairment would be considered other-than-temporary after one year.

8. The Task Force generally supported the proposed guidance with respect to its application to equity securities but asked that the Working Group further refine some of the specific guidance within each of the steps of the impairment model. The Task Force also requested that the Working Group further explore the application of Step 2 of the proposed guidance to certain debt securities, including the impact of an investor's ability and/or intent to hold an investment when it is not probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security that was not impaired at acquisition and the decline in its fair value is due only to interest rate fluctuations.

9. The Task Force also requested that the Working Group further consider the accounting for the investment after an impairment is recognized under Step 3 of the proposed model, specifically focusing on investments accounted for under the equity method.

10. At the May 15, 2003 EITF meeting, the Task Force discussed additional Working Group recommendations regarding the refinement of the proposed guidance for assessing other-than-temporary impairment. The Task Force expressed concern over the applicability and feasibility of a single impairment model for all types of investments. Consequently, the Task Force directed the FASB staff to consider whether the characteristics of different types of investments (for example, Statement 115 available-for-sale equity securities, Statement 115 available-for-sale and held-to-maturity debt securities, and investments subject to Opinion 18) require different models for evaluating whether or when an impairment is considered other than temporary.

11. At the July 31, 2003 EITF meeting, the Task Force discussed separate impairment models proposed by the FASB staff for each of the following categories of investments: (a) Statement 115 and Statement 124 equity securities, (b) Statement 115 and Statement 124 debt securities, (c) cost method investments (that is, equity securities that are not subject to the scope of Statement 115 and not accounted for under the equity method), and (d) equity method investments. Those models were generally consistent with the three-step approach proposed at the March meeting with the following exceptions:

- Under the models for cost method investments and equity method investments without a readily determinable fair value, Step 1 was modified to include certain triggers for when an impairment test should be performed
- Under each of the models, Step 2 was tailored to the nature of the investment. For example, the proposed model for debt securities includes a consideration of the probability of collection of contractual cash flows.

12. The Task Force generally supported the underlying principles in each of the proposed impairment models for equity securities, debt securities, and cost method investments. However, the Task Force suggested further refinement to those models to, among other things:

a. Eliminate the rebuttable presumption that an impairment is considered other than temporary after a one-year period of impairment

b. Further emphasize the notion that the weight of evidence indicating an other-than-temporary impairment increases as the length of time that an investment's fair value is below its carrying amount increases and that, therefore, greater positive evidence will be required to conclude that an impairment is temporary as the duration of impairment increases

c. Require the investor to disclose in its financial statements information about unrealized holding losses that have not been recognized as other-than-temporary impairments. Some Task Force members suggested disclosures about the aging of those unrealized losses, and some suggested disclosures about the evidence supporting the conclusion that the investments to which those losses relate are not other-than-temporarily impaired.

13. In addition, the Task Force suggested that the proposed impairment model for debt securities be further refined to clarify the intent and operation of the considerations in the proposed model for determining other-than-temporary impairment for investments in debt securities with noncontingent contractual cash flows. In particular, the Task Force agreed on the general principle that impairments due to deterioration in credit that result in a conclusion that noncollection is probable should be considered other than temporary. Other declines in fair value (for example, due to interest rate changes, sector credit rating changes, or company-specific rating changes that do not result in a conclusion that noncollection of contractual principal and interest is probable) may not result in a conclusion that an other-than-temporary impairment has occurred, subject to the other considerations in the proposed model. Therefore, the Task Force asked the Working Group to further refine Step 2 of the model for debt securities to differentiate those securities for which noncollection is probable from those securities for which collection is probable but which, based on other considerations, may be considered other-than-temporarily impaired. The Task Force also requested that the Working Group develop further guidance for determining what constitutes "noncontingent contractual cash flows."

14. For cost method investments, because fair value is not readily determinable, the Task Force generally agreed that investments should be tested for impairment annually, or more frequently if certain indicators are present, rather than at each reporting date. However, certain Task Force members expressed concerns that because information necessary to estimate the fair value of a cost method investment may not be readily available to the investor, even limiting the impairment test to an annual evaluation may not be practical. Therefore, the FASB staff will explore an alternative model that would require an impairment test only when certain indicators are present.

15. The Task Force agreed to consider further development of an impairment model for the fourth category of investments discussed—equity method investments—after the impairment models for other types of investments have been further refined.

16. In addition, the Task Force requested that, as the other models are refined, the FASB staff consider further the implications of including within or excluding from the scope of this Issue (a) investments of not-for-profit organizations and (b) beneficial interests in transferred financial assets subject to the scope of Issue 99-20. Some Task Force members also requested clarification of the classification, for purposes of this Issue, of investments in mutual funds that invest in debt securities and suggested that the classification follow the guidance in Question 5 of the Special Report on Statement 115, which indicates that an investor should not "look through" the form of an investment to the underlying investments of the investment vehicle.

Current EITF Discussion

17. At the November 12–13, 2003 EITF meeting, the Task Force discussed several of the recommendations set forth by the Working Group on the proposed models for evaluating impairment of equity securities and debt securities but was not asked to reach a consensus. However, the Task Force expressed support in general for the underlying principles and asked the FASB staff to consider the following refinements to certain of the elements in those models:

a. Recombine the separate models for (1) equity securities, (2) debt securities, and (3) cost method investments into a single model with unique steps or analyses where appropriate (for example, the trigger-based approach in Step 1 of the cost method model or the special guidance on subsequent accounting in the debt securities model).

b. Consider whether the other-than-temporary impairment considerations in this Issue that are incremental to the impairment considerations in Issue 99-20 should be incorporated directly into Issue 99-20.

c. Reconcile the principle of considering the relative weight of evidence in its entirety with the guidance that suggests a recent but precipitous decline in market value or a slight but protracted decline in market value could individually lead to a conclusion that an impairment is other than temporary. Some Task Force members expressed concern that the guidance regarding a recent but precipitous decline or a slight but protracted decline in market value, as currently presented, takes precedence over the entire evidence-based analysis.

d. In developing an evidence-based judgment about a forecasted market price recovery, the model should emphasize that the investor must consider and give appropriate and unbiased weighting to all reasonably available third-party information (as opposed to reliance on selected information).

e. For debt securities that cannot be contractually prepaid or otherwise contractually settled in such a way that the investor would not recover substantially all of its amortized cost, clarify whether collateral should be considered a guarantee or other credit enhancement for purposes of determining whether it is probable that the investor will be unable to collect all amounts due according to the contractual terms of the debt security.

f. Eliminate the reference to "a reasonable period of time" from the model for debt securities that cannot be contractually prepaid or otherwise contractually settled in such a way that the investor would not recover substantially all of its amortized cost. The Task Force believes that the "reasonable period of time" provision is irrelevant because the investor must assert its ability and intent to hold the investment until the earlier of (1) maturity or (2) a market price recovery.

18. Although the Task Force requested further revisions to the underlying impairment models, at the November 12–13, 2003 EITF meeting, the Task Force reached a consensus that certain quantitative and qualitative disclosures should be required for debt and marketable equity securities classified as available-for-sale or held-to-maturity under Statements 115 and 124 that are impaired at the balance sheet date but for which an other-than-temporary impairment has not been recognized.[1,2] For those investments with unrealized losses that have not been recognized as other-than-temporary impairments, the investor should disclose:

a. Quantitative information, aggregated by each category of investment that the investor discloses in accordance with Statements 115 and 124, in tabular form:
   (1) The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and
   (2) The aggregate related fair value of investments with unrealized losses.

   The disclosures in (1) and (2) above should be segregated by those investments that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer.[3]

b. Additional information, in narrative form, that provides sufficient information to allow financial statement users to understand the quantitative disclosures and the information that the investor considered (both positive and negative) in reaching the conclusion that the impairments are not other-than-temporary. This disclosure could include:
   (1) The nature of the investment(s)
   (2) The cause(s) of the impairment(s)
   (3) The number of investment positions that are in an unrealized loss position
   (4) The severity and duration of the impairment(s)
   (5) Other evidence considered by the investor in reaching its conclusion that the investment(s) is not other-than-temporarily impaired, including, for example, industry analyst reports, sector credit ratings, volatility of the security's market price, and/or any other information that the investor considers relevant.

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[1] The disclosures apply to investments held by a not-for-profit organization only if that organization reports a "performance indicator" as defined in the AICPA Audit and Accounting Guide, *Health Care Organizations*.

[2] Securities subject to EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," are not subject to the Task Force consensus related to disclosures.

[3] The reference point for determining how long an investment has been in an unrealized loss position is the balance sheet date of the reporting period in which the continuing impairment was first identified. For enterprises that do not prepare quarterly financial information, the reference point would be the annual balance sheet date of the period during which the impairment was identified, unless the investment experienced a market price recovery between balance sheet dates. In that case, the balance sheet date of the period in which the security again became impaired shall be the reference point.

A tabular example of the quantitative disclosures in sub-paragraph (a) is attached in Exhibit 03-1A.

Transition and Effective Date

19. The consensus on quantitative and qualitative disclosures in paragraph 18 is effective for fiscal years ending after December 15, 2003. Comparative information for earlier periods presented is not required.

Board Ratification

20. At its November 25, 2003 meeting, the Board ratified the consensus reached by the Task Force described in paragraph 18.

Status

21. Further discussion is expected at a future meeting.

Exhibit 03-1A

EXAMPLE OF THE APPLICATION OF THE EITF CONSENSUS ON DISCLOSURES ABOUT INVESTMENTS IN AN UNREALIZED LOSS POSITION THAT ARE NOT OTHER-THAN-TEMPORARILY IMPAIRED

The following table shows our investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2003.

	Less than 12 months		**12 months or more**		**Total**	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
US Treasury obligations and direct obligations of US government agencies	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX
Federal agency mortgage backed securities	XX	XX	XX	XX	XX	XX
Corporate bonds	XX	XX	XX	XX	XX	XX
Subtotal, debt securities	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX
Common stock	XX	XX	XX	XX	XX	XX
Total temporarily impaired securities	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX

A specific illustration of the additional disclosures described in paragraph 18(b) regarding the information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary is subject to future Task Force discussions. However, pending the outcome of those discussions, the investor should disclose information responsive to the guidance in paragraph 18(b) in the same context as the tabular disclosures illustrated above.

Issue No. 03-6

Title: Participating Securities and the Two-Class Method under FASB Statement No. 128, *Earnings per Share*

Dates Discussed: May 15, 2003; July 31, 2003; November 12–13, 2003

References: FASB Statement No. 107, *Disclosure about Fair Value of Financial Instruments*

FASB Statement No. 128, *Earnings per Share*

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

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

Proposed FASB Statement, *Earnings per Share and Disclosure of Information about Capital Structure*, issued January 1996

APB Opinion No. 15, *Earnings per Share*

AICPA Accounting Interpretation 85, "EPS Treatment of Two-Class and Participating Securities," of APB Opinion No. 15

AICPA Accounting Interpretation 86, "Two-Class Method for Nonconvertible Securities," of APB Opinion No. 15

AICPA Accounting Interpretation 87, "Two-Class Method for Convertible Securities," of APB Opinion No. 15

Introduction

1. Statement 128 provides guidance on the calculation and disclosure of earnings per share (EPS). Statement 128 defines EPS as "the amount of earnings attributable to each share of common stock" and indicates that the objective of EPS is to measure the performance of an entity over the reporting period. In its deliberations of Statement 128, the Board decided to require the use of the two-class method of computing EPS for those enterprises with participating securities or multiple classes of common stock.

2. Paragraph 60(a) of Statement 128 provides the following description of participating securities:

> Securities that may participate in dividends with common stocks according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share).

Paragraph 61 of Statement 128 adds the following:

> The if-converted method shall be used for those securities that are convertible into common stock if the effect is dilutive. For those securities that are not

convertible into a class of common stock, the "two class" method of computing earnings per share shall be used. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Under that method:

a. Income from continuing operations (or net income) shall be reduced by the amount of dividends declared in the current period for each class of stock and by the contractual amount of dividends (or interest on participating income bonds) that must be paid for the current period (for example, unpaid cumulative dividends).[25]

b. The remaining earnings shall be allocated to common stock and participating securities to the extent that each security may share in earnings as if all of the earnings for the period had been distributed. The total earnings allocated to each security shall be determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.

c. The total earnings allocated to each security shall be divided by the number of outstanding shares of the security to which the earnings are allocated to determine the earnings per share for the security.

d. Basic and diluted EPS data shall be presented for each class of common stock.

For the diluted EPS computation, outstanding common shares shall include all potential common shares assumed issued. Illustration 6 in Appendix C provides an example of that provision.

[25]Dividends declared in the current period do not include dividends declared in respect of prior-year unpaid cumulative dividends. Preferred dividends that are cumulative only if earned are deducted only to the extent that they are earned.

3. Subsequent to the issuance of Statement 128, the FASB staff issued *EITF Abstracts*, Topic No. D-95, "Effect of Participating Convertible Securities on the Computation of Basic Earnings per Share," to address the effect of participating convertible securities on the computation of basic EPS. Topic D-95 clarifies that participating securities that are convertible into common stock be included in the computation of basic EPS if the effect is dilutive. Topic D-95 states that the determination of how participating convertible securities should be included in the computation of basic EPS (that is, using either the if-converted method or the two-class method) is an accounting policy decision; however, the dilutive effect on basic EPS cannot be less than that which would result from the application of the two-class method that would be required if the same security were not convertible.

4. Consider the following example:

Company ABC has 10,000 shares of common stock and 5,000 shares of convertible preferred stock outstanding. Each share of preferred stock is convertible into one share of common stock. The preferred stock participates in any dividends on a 1:1 per share ratio with common stock. That is, the preferred stock receives dividends at a rate that results in a per share amount that is equivalent to the per share amount paid on common stock. Company ABC had net income of $50,000 for 20X3 and paid no dividends during 20X3. Company ABC has an accounting policy that preferred stock will be included in its computation of basic EPS using the if-converted method as long as the dilutive effect on basic EPS is at least as great as the effect of the two-class method.

Company ABC could not compute basic EPS excluding the convertible participating securities ($5.00 per share[1]), as the effect of the convertible preferred stock is dilutive. Instead, Company ABC would compute basic EPS using the if-converted method ($3.33 per share[2]), as the dilutive effect that would result from including the effect of the convertible preferred stock under the if-converted method is no less than that which would result from the application of the two-class method if the preferred stock were not convertible ($3.33 per share[3]).

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[1] *Computation of basic EPS excluding the convertible preferred stock:*

$$\frac{\text{Net income available to common shareholders}}{\text{Outstanding shares}} = \text{Basic EPS}$$

$$\frac{\$50{,}000}{10{,}000 \text{ shares}} = \$5.00 \text{ per share}$$

[2] *Computation of basic EPS using if-converted method:*

$$\frac{\$50{,}000}{15{,}000 \text{ shares}} = \$3.33 \text{ per share}$$

Note: Conversion of the preferred stock results in 15,000 shares of common stock outstanding.

[3] *Computation of basic EPS using two-class method:*

$$\text{Undistributed 20X3 earnings} = \text{Net income} - \text{Dividends}$$

$$\$50{,}000 = \$50{,}000 - \$0$$

Allocation of undistributed earnings:

To common stock:

$$\frac{(10{,}000)}{[(5{,}000) + (10{,}000)]} \times \$50{,}000 = \$33{,}333$$

$$\frac{\$33{,}333}{10{,}000 \text{ shares}} = \$3.33 \text{ per share}$$

To preferred stock:

$$\frac{(5{,}000)}{[(5{,}000) + (10{,}000)]} \times \$50{,}000 = \$16{,}667$$

$$\frac{\$16{,}667}{5{,}000 \text{ shares}} = \$3.33 \text{ per share}$$

	Common	Preferred
Distributed earnings	$0.00	$0.00
Undistributed earnings	3.33	3.33
Totals	$3.33	$3.33

5. The Issues are:

Issue 1— Whether the two-class method requires the presentation of basic and diluted EPS for all participating securities.

Issue 1(a)— If the two-class method does not require the presentation of basic and diluted EPS for all participating securities, when the presentation of basic and diluted EPS is appropriate.

Issue 2— How a participating security that requires application of paragraph 61 of Statement 128 should be defined.

Issue 2(a)— Whether all potential common shares, that is, securities or other contracts that may entitle their holders to obtain common stock (such as options, warrants, forwards, convertible debt, and convertible preferred stock), may be participating securities.

Issue 2(b)(i)—Whether dividends or dividend equivalents paid to the holder of a convertible security that are applied to either reduce the conversion price or increase the conversion ratio of the security represent participation rights.

Issue 2(b)(ii)—Whether an issuing entity should recognize a dividend equivalent that is applied to reduce the conversion price or increase the conversion ratio of a convertible security in its financial statements and, if so, how those dividend equivalents should be recognized in the financial statements.

Issue 2(b)(iii)—If the Task Force reaches a consensus in Issue 2(b)(i) that the dividends or dividend equivalents in question represent participation rights, how convertible securities that participate in dividends via a reduction in the conversion price or an increase in the conversion ratio should be considered by the issuer in the computation of basic EPS.

Issue 3— How undistributed earnings should be allocated to a participating security.

Issue 4— Whether an entity that allocated undistributed earnings to a nonconvertible participating security would continue to do so in a period of net loss if the effect is antidilutive.

Issue 5— Whether a convertible participating security would be excluded from the computation of basic EPS if an entity has a net loss from continuing operations.

Issue 6— How a convertible participating security is included in the computation of diluted EPS.

Prior EITF Discussion

6. At the May 15, 2003 EITF meeting, the Task Force discussed those issues, but was not asked to reach a consensus. Members of the Task Force requested that the FASB staff organize an advisory group that would explore the Issue further and create a revised Issue Summary for discussion at a future meeting. The Task Force requested that the advisory group specifically address conditions under which a participating security requires (a) the use of the two-class method, (b) an adjustment to earnings available to common shareholders, or (c) disclosure in accordance with Statement 129. The Task Force requested that the advisory group provide specific examples of securities for which participation may be ambiguous or for which participation rights are contingent (for example, a warrant with an exercise price that changes based on dividends).

7. At the July 31, 2003 EITF meeting, the Task Force reached a tentative conclusion on Issue 1 that the two-class method is an earnings allocation formula that treats a participating security as having rights to earnings that otherwise would have been available to common shareholders, but does not require the presentation of basic and diluted EPS for securities other than common stock. However, the Task Force observed that the presentation of basic and diluted EPS for a participating security other than common stock is not precluded.

8. The Task Force decided to discontinue its discussion on Issue 1(a), noting that although the presentation of basic and diluted EPS for a participating security other than a class of common stock may be desirable in some cases, it is not required by Statement 128.

9. The Task Force reached a tentative conclusion on Issue 2 that, for purposes of applying paragraphs 60 and 61 of Statement 128, a participating security is a security that may participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not. The Task Force observed that the form of such participation does not have to be a dividend—that is, any form of participation in undistributed earnings would constitute participation by that security, regardless of whether the payment to the security holder was referred to as a dividend.

10. The Task Force discussed but was not asked to reach a consensus on Issue 2(a). Some Task Force members noted a preference for the view that a potential common share that has a current right to participate in earnings would be a participating security and that basic and diluted EPS should be calculated as the more dilutive of the two-class method or the method prescribed by Statement 128 or related authoritative guidance (for example, the treasury stock method or the reverse treasury stock method). The Task Force asked the FASB staff to further explore Issue 2(a) with the Advisory Group and prepare examples for discussion at a future meeting.

11. The Task Force discussed but was not asked to reach a consensus on Issue 3. However, the Task Force generally preferred the view that undistributed earnings for a period should be allocated to a participating security based on the *contractual* participation rights of the security to share in those current earnings. If the terms of a security do not specify objectively determinable, nondiscretionary participation rights, then undistributed earnings would not be allocated based on arbitrary assumptions. Also, if an entity could avoid distributions of undistributed earnings to participating security holders, then no allocation of that period's

earnings to the participating security would be made. Participation rights that are contingent on or subject to the discretion of the company should be fully disclosed in accordance with paragraph 4 of Statement 129.

12. The Task Force reached a tentative conclusion on Issue 4 that an entity would continue to allocate undistributed earnings/losses to a nonconvertible participating security in periods of net loss even if the effect is antidilutive. The Task Force observed that losses that reduce the undistributed earnings in which a participating security has a right to share should be allocated to that participating security.

13. The Task Force did not discuss Issues 2(b), 5, or 6. The Task Force also asked the staff to develop alternative views, for discussion at a future meeting, as to how EPS calculations would be affected by participation features that take the form of a derivative that is marked to market through the income statement in accordance with authoritative guidance such as Statement 133.

Current EITF Discussion

14. At the November 12–13, 2003 EITF meeting, the Task Force discussed the tentative conclusions previously reached on Issues 1 and 2 at the July 31, 2003 meeting and reaffirmed those tentative conclusions. However, the Task Force was not asked to reach a consensus.

15. The Task Force decided to defer further discussion on Issue 2(a) and requested that the FASB staff explore a reconsideration of the guidance in Topic D-95 to address other forms of participating securities, including potential common stock securities such as the options and warrants addressed in Issue 2(a).

16. The Task Force reached a tentative conclusion on Issue 2(b)(i) that dividends or dividend equivalents transferred to the holder of a convertible security in the form of a reduction to the conversion price or an increase in the conversion ratio of the security do not represent participation rights. The Task Force noted that while this Issue was discussed in the context of a convertible security, the tentative conclusion would apply similarly to other contracts (securities) to issue an entity's common stock if these contracts (securities) provide for an adjustment to the exercise price that is tied to the declaration of dividends by the issuer.

17. The Task Force reached a tentative conclusion on Issue 2(b)(ii) that the issuing entity should consider a dividend equivalent that is applied to reduce the conversion price or increase the conversion ratio of a convertible security in its financial statements as a contingent beneficial conversion feature. The contingent beneficial conversion feature should be recognized in the issuing entity's financial statements in accordance with the guidance in EITF Issues No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," and No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments." Specifically, the issuing entity should look to Issue 7 of Issue 00-27, by analogy, in determining how and when to recognize the terms of a contingent conversion option in its financial statements.

18. The Task Force decided to discontinue discussion on Issue 2(b)(iii), noting that the tentative conclusion reached in Issue 2(b)(i) obviates the question of how to treat those securities under the two-class method for EPS purposes.

19. The Task Force reached a tentative conclusion on Issue 3 that undistributed earnings for a period should be allocated to a participating security based on the contractual participation rights of the security to share in those current earnings as if all of the earnings for the period had been distributed. If the terms of the participating security do not specify objectively determinable, nondiscretionary participation rights, then undistributed earnings would not be allocated based on arbitrary assumptions. For example, if an entity could avoid distribution of earnings to a participating security, even if all of the earnings for the year were distributed, then no allocation of that period's earnings to the participating security would be made.

20. The Task Force observed that paragraph 61(b) of Statement 128 states that under the two-class method "the remaining earnings shall be allocated to common stock and participating securities to the extent that each security may share in earnings *as if all of the earnings for the period had been distributed*" (emphasis added). The Task Force noted that the tentative conclusion on Issue 3 is based on that guidance in Statement 128, despite the pro forma nature of this allocation and that it may not reflect the economic probabilities of actual distributions to the participating security holders.

21. To illustrate application of the tentative conclusion reached on Issue 3, consider the following examples (Note: In all cases set forth below, the participation rights of the securities may be required to be disclosed in accordance with the provisions of Statement 129, regardless of whether undistributed earnings are allocated to the participating security.):

> **<u>Example A:</u>** A participating security that provides the holder with the ability to participate in all dividends declared with the holders of common stock on a 1:1 per-share basis.
>
> **Evaluation:** The undistributed earnings should be allocated between the common stock and the participating security on a 1:1 per-share basis.
>
> **<u>Example B:</u>** A participating security that provides the holder with the ability to participate with the holders of common stock in dividends declared contingent upon the occurrence of a specified event, the occurrence of which is subject to management discretion or is not objectively determinable (for example, liquidation of the company or management determination of an "extraordinary" dividend).
>
> **Evaluation:** The terms of the participating security in this scenario do not specify objectively determinable, nondiscretionary participation rights; therefore, undistributed earnings would not be allocated to the participating security.
>
> **<u>Example C:</u>** A participating security that provides the holder with the ability to participate with the holders of common stock in earnings for a period in which a specified event occurs,

regardless of whether a dividend is paid during the period (for example, achievement of a target market price of a security or achievement of a certain earnings level).

Evaluation: Undistributed earnings would be allocated to common stock and the participating security based on the assumption that all of the earnings for the period are distributed. Undistributed earnings would be allocated to the participating security if the contingent condition would have been satisfied at the reporting date, irrespective of whether an actual distribution was made for the period.

Example D: A participating security that provides the holder with the ability to participate in extraordinary dividends. The classification of dividends as extraordinary is predetermined by a formula, for example, any dividend per common share in excess of 5 percent of the current market price of the stock is defined as extraordinary.

Evaluation: Undistributed earnings would be allocated to common stock and the participating security based on the assumption that all of the earnings for the period are distributed. If earnings for a given period exceed the specified threshold above which the participating security would participate (that is, earnings for the period are in excess of 5 percent of the current market price of the stock), undistributed earnings would be allocated to the participating security according to its terms.

Example E: A participating security that provides the holder with the ability to participate in extraordinary dividends. The classification of dividends as extraordinary is within the sole discretion of the board of directors.

Evaluation: Undistributed earnings would be allocated only to common stock. Since the classification of dividends as extraordinary is within the sole discretion of the board of directors, undistributed earnings would not be allocated to the participating security as the participation in the undistributed earnings would not be objectively determinable.

Example F: A participating security that provides the holder with the ability to participate in all dividends up to a specified threshold. For example, the security participates in dividends per common share up to 5 percent of the current market price of the stock.

Evaluation: Undistributed earnings would be allocated to common stock and the participating security based on the assumption that all of the earnings for the period are distributed. In this example, undistributed earnings would be allocated to common stock and to the participating security up to 5 percent of the current market price of the common stock, as the amount of the threshold for participation by the participating security is objectively determinable. The remaining undistributed earnings for the period would be allocated to common stock.

22. The Task Force discussed the tentative conclusion previously reached on Issue 4 and tentatively concluded that an entity would allocate losses to a nonconvertible participating security in periods of net loss if, based on the contractual terms of the participating security, the security had not only the right to participate in the earnings of the issuer, but also a contractual obligation to share in the losses of the issuing entity on a basis that was objectively determinable. Determination of whether a participating security holder has an obligation to share in the losses of the issuing entity in a given period must be made on a period by period basis, based on the contractual rights and obligations of the participating security.

23. The Task Force reached a tentative conclusion on Issue 5 that a convertible participating security should be included in the computation of basic EPS in periods of net loss if, based on its contractual terms, the convertible participating security has the contractual obligation to share in the losses of the issuing entity on a basis that is objectively determinable. The Task Force agreed that the basis for the tentative conclusion reached in Issue 4 would also apply to the inclusion of convertible participating securities in basic EPS, irrespective of the differences that may exist between convertible and nonconvertible securities. That is, an entity should not automatically exclude a convertible participating security from the computation of basic EPS if an entity has a net loss from continuing operations. Determination of whether a participating security holder has an obligation to share in the losses of the issuing entity in a given period must be made on a period by period basis, based on the contractual rights and obligations of the participating security.

24. The Task Force decided to discontinue its discussion on Issue 6 noting that convertible participating securities should be included in the computation of diluted EPS using the if-converted method, subject to the antidilution provisions of Statement 128.

Status

25. Further discussion is expected at a future meeting.

Issue No. 03-8

Title: Accounting for Claims-Made Insurance and Retroactive Insurance Contracts by the Insured Entity

Dates Discussed: March 13–14, 1986; May 1, 1986; July 24, 1986; May 19–20, 1999; May 15, 2003; July 31, 2003; November 12–13, 2003

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

FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*

FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*

FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*

AICPA Statement of Position 96-1, *Environmental Remediation Liabilities*

AICPA Statement of Position 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*

AICPA Audit and Accounting Guide, *Health Care Organizations*

ISSUE

1. The purpose of this Issue is to codify and reconcile the guidance contained in the following Issues, which address the accounting by the insured entity for claims-made insurance and retroactive insurance contracts:

- Issue No. 86-12, "Accounting by Insureds for Claims-Made Insurance Policies"
- Issue No. 03-3, "Applicability of Topic No. D-79 to Claims-Made Insurance Policies"
- Topic No. D-79, "Accounting for Retroactive Insurance Contracts Purchased by Entities Other Than Insurance Enterprises."

This Issue does not apply to reinsurance transactions.

2. Many entities use claims-made policies to satisfy their insurance needs for such coverage as product, directors and officers (D&O), and malpractice liabilities. However, in recent years entities have been purchasing coverage for a variety of other exposures using a claims-made format. Under a claims-made insurance policy, an entity is insured for any claims reported during the term of the policy, in many cases including those that occurred prior to the policy effective date, but after the specified retroactive date.

3. Generally, entities purchasing a claims-made policy will renew the policy each year. The amount of coverage purchased may change over time to meet current needs (for example, changing risk within the entity) or to respond to the overall environment (for example, the expected settlement costs of the same claim today may cost more than in prior years). When

operations cease, the entity generally purchases tail-coverage to insure itself against any previously unasserted claims. Presuming the entity can renew the claims-made policy each year and can obtain tail coverage when desired, such a strategy effectively converts the claims-made policy into an occurrence-based policy covering the entity for any claim made against it. Entities generally use claims-made coverage because it is the only form of insurance available for certain exposures, particularly, exposures for which the occurrence dates may be difficult to determine or for which the occurrence may span a long period of time. Therefore, a claims-made policy mitigates potential coverage disputes because the occurrence date generally is not relevant to the determination of coverage. Also, there may be reduced insurance costs in the first several years of a claims-made policy as compared to an occurrence-based policy. Many entities that purchase claims-made insurance policies have no knowledge of unasserted outstanding claims or, because their liabilities have not met the recognition criteria contained in Statement 5 or in other applicable U.S. GAAP, have no recognized liability for claims, including incurred but not reported (IBNR)[1] claims. In other situations, however, entities that purchase claims-made insurance policies are aware of potential claims based on a specific incident(s) or historical experience. In those situations, unasserted claims can be either specifically excluded from or specifically included in the coverage.

4. The issues are:

Issue 1— How an insured entity, including an insurance entity purchasing insurance unrelated to its core insurance operations, (for example, manufacturing concerns, retailers, service entities, and financial institutions) should account for a purchased retroactive insurance policy and whether the transaction results in gain recognition (excluding reinsurance transactions). For example, a company records a liability of $100 million incurred as a result of a past event in accordance with Statement 5. The company then buys an insurance policy for $60 million to cover that liability.

Issue 2— Whether a claims-made insurance policy represents a purchased retroactive insurance contract subject to the consensus in Issue 1.

Issue 3(a)—Whether an insured entity should recognize a liability at the balance sheet date for IBNR claims.

Issue 3(b)—If the probable losses from IBNR claims and incidents cannot be reasonably estimated, whether a liability may be accrued based on the estimated cost of purchasing "tail" coverage, which would insure the entity for events that occur during the claims-made policy period but are not reported to the insurance carrier in that period.

Issue 4(a)—In situations in which an entity's fiscal year and policy term coincide and the contract is prospective, the appropriate accounting for both (a) the IBNR liability in subsequent periods when the entity purchases another claims-made insurance policy that, in part, covers a portion of the losses included in the IBNR liability and (b) the

[1] Paragraph 8.05~~3~~ through 8.12~~3~~ of the Health Care Organizations Guide provides further guidance on the recognition of a liability for claims incurred but not reported.

premiums for that subsequent claims-made insurance policy.

Issue 4(b)—The accounting ramifications on the consensus reached in Issue 4(a) of having a prospective claims-made policy term that does not coincide with the enterprise's fiscal year.

Issue 5— Disclosures that should be made by companies insured under claims-made policies.

EITF DISCUSSION

Issue 1—How an insured entity, including an insurance entity purchasing insurance unrelated to its core insurance operations, (for example manufacturing concerns, retailers, service entities, and financial institutions) should account for a purchased retroactive insurance policy and whether the transaction results in gain recognition (excluding reinsurance transactions). For example, a company records a liability of $100 million incurred as a result of a past event in accordance with Statement 5. The company then buys an insurance policy for $60 million to cover that liability.

5. The scope of Issue 1 is limited to retroactive insurance contracts that (a) do not legally extinguish the entity's liability, (b) meet the indemnification against loss or liability conditions of Statement 5, (c) provide indemnification against loss or liability relating to liabilities that have been incurred as a result of a past event for example, environmental remediation liabilities,[2] and (d) are not reinsurance transactions. The Task Force observed that paragraph 44 of Statement 5 requires that an enterprise determine whether insurance risk has been transferred through an insurance contract; entities may find the conditions in Statement 113 useful in assessing whether an insurance contract transfers risk.

6. Statement 113 specifies the accounting by insurance enterprises for reinsurance contracts. Reinsurance contracts that do not meet the conditions for reinsurance accounting under Statement 113 are to be accounted for as deposits.[3] The Task Force observed that Appendix C of Statement 113 defines retroactive reinsurance as follows:

> Reinsurance in which an assuming enterprise agrees to reimburse a ceding enterprise for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance.

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[2] SOP 96-1, provides accounting guidance for environmental remediation liabilities within its scope. The SOP provides that the amount of an environmental remediation liability should be determined independently from any potential claim for recovery and that an asset relating to the recovery should be recognized only when realization of the claim for recovery is deemed probable. Fair value should be used to measure the amount of a potential recovery. The concept of fair value requires consideration of both transaction costs related to the receipt of the recovery and the time value of money. However, the time value of money should not be considered in the determination of the recorded amount of a potential recovery if (a) the liability is not discounted and (b) the timing of the recovery is dependent on the timing of the payment of the liability. The SOP does not address the accounting for the purchase of retroactive insurance contracts.

[3] SOP 98-7 provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk.

7. Notwithstanding that Statement 113 applies only to insurance enterprises, the Task Force reached a consensus that purchased retroactive insurance contracts that indemnify the insured should be accounted for in a manner similar to the manner in which retroactive reinsurance contracts are accounted for under Statement 113. The guidance in paragraphs 22-25 of Statement 113 should be applied, as appropriate, based on the facts and circumstances of the particular transaction. That is, amounts paid for retroactive insurance should be expensed immediately. Simultaneously, a receivable should be established for the expected recoveries related to the underlying insured event. If the receivable established exceeds the amounts paid for the insurance, the resulting gain is deferred. If the amounts and timing of the insurance recoveries can be reasonably estimated, the deferred gain should be amortized using the interest method over the estimated period over which the entity expects to recover substantially all amounts due under the terms of the insurance contract. If the amounts and timing of the insurance recoveries cannot be reasonably estimated, then the proportion of actual recoveries to total estimated recoveries should be used to determine the amount of the amortization. Immediate gain recognition and liability derecognition are not appropriate because the liability has not been extinguished (the entity is not entirely relieved of its obligation). Additionally, the Task Force observed that the liability incurred as a result of a past insurable event and amounts receivable under the insurance contract do not meet the criteria for offsetting under Interpretation 39.

8. The Task Force observed that if the purchased insurance contract includes coverage for legal and other costs, the accounting for legal and other costs should be consistent between the asset and the liability. That is, if the entity's accounting policy is to accrue for those costs, then the insurance receivable also should reflect those costs if they are covered under the terms of the insurance policy. If an entity's accounting policy is not to accrue for those costs, then the insurance receivable should not reflect those costs on an accrual basis.

Issue 2—Whether a claims-made insurance policy represents a purchased retroactive insurance contract subject to the consensus in Issue 1.

9. The Task Force reached a consensus that a claims-made insurance policy contains a retroactive provision if it provides coverage for specific, known claims that were reportable[4] prior to the policy period. If a claims-made insurance policy contains a retroactive provision, the retroactive and prospective provisions of the policy should be accounted for separately, if practicable. If it is not practicable to separate the retroactive and prospective provisions, the claims-made insurance policy should be accounted for entirely as a retroactive contract in accordance with paragraphs 22-25 of Statement 113. A claims-made insurance policy that

[4] The phrase *specific, known claims that were reportable* (by the insured entity to the insurance carrier) would encompass asserted claims, known unasserted claims, and any known previous event or circumstance that might result in a specific claim (whether asserted or unasserted), regardless of whether the insured has recognized a loss contingency for those claims. Such claims include those claims that were not reported by the insured to the insurance carrier, but would have been reportable to the carrier had a claims made policy been in place in a prior period. A recognized liability for claims for losses related to events that the insured is not specifically aware of but expects to be reported to the insurance carrier (IBNR) (and, therefore, are not yet reportable), generally would not be determinative in concluding that the claims-made insurance policy contains a retroactive provision.

contains no retroactive provisions should be accounted for on a prospective basis as described in the consensuses reached in Issues 4(a) and 4(b).

10. The Task Force observed that paragraph 95 of Statement 113 states that "in claims-made insurance, the insured event is the reporting to the insurer, within the period specified by the policy, of a claim for a loss covered by the insurance contract." Accordingly, a prospective claims-made insurance policy only covers claims for losses reportable to the insurer during the policy term. A retroactive provision provides coverage for known claims, for which the underlying event had occurred and the incident would have been reportable prior to the effective date of the claims-made policy. The Task Force noted that a recognized liability for IBNR claims generally would not be determinative in concluding that a claims-made insurance policy either does or does not contain a retroactive provision.

11. In reaching its consensus, the Task Force also noted that all relevant facts and circumstances should be considered in evaluating whether a claims made policy contains a retroactive provision. The Task Force provided the following indicators that a claims-made insurance policy does not contain a retroactive provision (that is, it is not providing coverage for previously reportable claims) and, therefore, should be accounted for on a prospective basis. No one indicator is determinative in this evaluation; the determination must be made upon the specific facts and circumstances:

a. The insured consistently purchases claims-made insurance policies as part of its risk management program for the specific type of risk being insured, and tail coverage for both prior periods and prior policies is readily available and not excessively priced as compared to tail coverage offered to similar companies, that do not contain retroactive provisions.

b. The claims-made insurance policy is responsive to unknown risks for a finite or limited period of time, as evidenced by the fact that (1) the type of risk being insured is inherently short-tailed, that is, the claims are incurred during the policy period and paid out in their entirety shortly after the end of the policy period, (2) the policy term is for a limited period of time (for example, one-year coverage), (3) claims-made coverage is the most readily available coverage for this type of insurance risk, and (4) the occurrence date of the type of risk covered by the policy is unclear (that is, the causal event that gives rise to an insured claim is difficult to determine).[5]

c. The claims-made insurance policy contains an unambiguous trigger indicating that a claim is covered by the policy. That contract trigger should not be subject to interpretation, negotiation, or manipulation. An example of an unambiguous "trigger" that indicates that a claim is covered by a claims-made insurance policy would include the following provisions:

    i. The insured notifies the insurance carrier during the policy term that a claim has been asserted, or that an incident has occurred, and

[5] Such a lack of identification creates difficulty in assessing risk for an entity considering whether to self-insure its insurance risk (for example, a manufacturing entity may be completely unaware of the potential health hazards attributable to its core products, and may want to protect itself in case a by-product of its production process becomes the next "asbestos").

   ii. The insured must represent that it was not aware of any such incident when the claims-made policy was purchased.

d. The premium charged for the claims-made insurance policy is not significantly in excess of the premium that would be charged for a claims-made insurance policy that could be purchased by a similar entity with similar insurance risks and that has no knowledge of any circumstances or events that would result in any claims, excluding any anticipated amounts for a typical number of claims for which the insured is not aware to have specifically occurred, but that it expects would be reported (IBNR).

e. The insurer may base the premium for the claims-made insurance policy on estimates and predictions that are based on the past experience of the insured, but the premium is not based on settlement estimates of specific, known events that are expected to be recovered under the policy.

f. The premium charged for the policy in the current year is not significantly in excess of that charged in previous years, other than for increases in the amount or type of coverage. An anticipated increase in premiums that is expected to occur because the insured entity is advancing toward the "mature-stage" of premiums for claims-made insurance would not be considered in making that determination.

g. The claims-made insurance policy is primarily intended to cover insurance risk and is not a financing arrangement. Claims-made insurance policies that are intended to cover insurance risk typically include features such as (a) an absence of adjustment features based on experience and (b) coverage of the ultimate loss from the claim, once made, regardless of period of settlement.

h. If the claims-made insurance policy has a specified retroactive date prior to the inception of the claims-made relationship with the insurer, the period from that specified retroactive date to the inception of the claims-made relationship with that insurer is either short or covered by other insurance policies.

12. The Task Force further observed that although the consensus in Issue 1 applies to situations in which the insured entity uses a claims-made insurance policy to finance known losses, (that is, when the insurance contract was purchased in order to provide insurance coverage for specific, known events that occurred or were reportable prior to the inception of the contract), the consensus in Issue 1 does not preclude prospective accounting for those claims-made insurance policies or portions of those policies that contain only prospective provisions.

13. The Task Force also observed that an insured entity may, for various reasons, contemporaneously enter into multiple claims-made insurance policy contracts. In those circumstances, an entity should consider whether those insurance contracts should be combined in order to determine the appropriate accounting treatment. The guidance contained in paragraph 8 of Statement 113 is helpful in those instances.

14. Examples to illustrate the application of this consensus are included in Exhibit 03-8A.

Issue 3(a)— Whether an insured entity should recognize a liability at the balance sheet date for IBNR claims.

15. The Task Force reached a consensus that Statement 5 requires insured entities (except for those in the scope of Statement 113), including those that use~~s~~ a claims-made approach for insuring certain risks, to recognize a liability for the probable losses from IBNR claims and incidents if both criteria in paragraph 8 of Statement 5 are met, that is, if the loss is both probable and reasonably estimable. The Task Force also observed that unless the conditions of Interpretation 39 are met, offsetting prepaid insurance and receivables for expected recoveries from insurers against a recognized IBNR liability or the liability incurred as a result of a past insurable event would not be appropriate.

Issue 3(b)—If the probable losses from IBNR claims and incidents cannot be reasonably estimated by an insured entity that uses a claims-made insurance approach to insure certain risks, whether that entity may measure the liability based on the estimated cost of purchasing "tail" coverage, which would insure the company for claims and incidents that occur during the claims-made policy period but are not reported to the insurance carrier in that period.

16. The Task Force reached a consensus that the estimated cost of purchasing tail coverage is not relevant in determining the loss to be accrued because Interpretation 39 prohibits netting the insurance receivable against the claim liability. However, the Task Force noted that, if the insured entity had the unilateral option to purchase tail coverage at a premium not to exceed a specified fixed maximum, then the insured entity could record a receivable for expected insurance recoveries (after considering deductibles and policy limits) for the portion of the IBNR liability that is insurable under the tail coverage. In that case, the entity would need to record as a cost the expected premium for the tail coverage. The Task Force also agreed that the purchase of tail coverage does not eliminate the need to determine if an additional liability should be accrued because of policy limits or other factors.

Issue 4(a)—In situations in which an entity's fiscal year and policy term coincide, the appropriate accounting for both (a) the insured liability (including IBNR) and the related insurance recoverable in subsequent periods when the entity purchases another prospective claims-made insurance policy that, in part, covers a portion of the losses included in the IBNR liability and (b) the premiums for that subsequent prospective claims-made insurance policy.

17. Regarding interim financial reporting, the Task Force reached a consensus that when the enterprise's fiscal year and policy year coincide, an appropriate method would be to recognize expense—through a combination of (a) accruing the IBNR liability, (b) accruing any expected increase in insurance recoverables, and (c) amortizing the insurance premium—on a pro rata basis over the year. In addition, the liability for any unusual claims or incidents, as well as any applicable insurance recoverable related thereto, would be recognized in the interim period in which they become known.

18. For interim reporting, the approach treats usual recurring losses as integral to annual reporting, and, therefore, any expected changes in the IBNR liability and related insurance recoverables that are not related to specific events can be spread over the entire year. However, material unusual losses must be accounted for as discrete items and recognized as they occur. The approach discussed in Issue 4(a) assumes the recurring purchase of a claims-made insurance policy with a one-year term and the payment of premiums on the first day of each policy year.

19. Members of the Task Force observed that when the enterprise's fiscal year and policy term coincide, the year-end IBNR liability relates to the enterprise's obligation for claims and incidents that have been incurred prior to year-end but will be reportable after year-end. The approach for accounting by policyholders who purchase claims-made insurance policies that consist of prospective provisions is as follows:

a. The premium paid at the beginning of the fiscal year for the new claims-made insurance policy should be recognized as a prepaid expense.

b. At the beginning of the fiscal year, the enterprise should estimate its IBNR liability as of the end of the fiscal year. That estimate involves estimating the claims and incidents that will be incurred prior to year-end but will not be reportable until after year-end. Presumably the estimated year-end IBNR liability would approximate the beginning IBNR liability adjusted for relevant historical patterns unless the enterprise has identified new factors (such as a major change in products, manufacturing processes, or risk management systems) that warrant further adjustment of the ending IBNR liability.

c. The enterprise should compute an estimated annual expense as the sum of (1) the premium paid for the claims-made policy, (2) the difference between the beginning IBNR liability and the estimated year-end IBNR liability, and (3) the difference between the beginning insurance recoverable related to the IBNR liability and the estimated ending amount. That estimated annual expense should be recognized in interim periods based on the methodology that best reflects the manner in which the benefits of the insurance coverage are consumed and the IBNR liability is incurred.[6] In addition, liabilities for specific claims incurred during the year that are not included in the IBNR estimate should be recognized as expense in the interim period in which they are incurred.

d. The estimated year-end IBNR liability should be reviewed whenever interim financial statements are prepared. Routine adjustments to the estimated liability would be recognized ratably in each of the remaining interim periods. However, if events and circumstances in that interim period indicate that unusual claims and incidents have been incurred prior to the end of the interim period, the enterprise should recognize in that interim period any related

[6] Insurance premiums are typically amortized over the policy period on a straight-line basis, since that matches the cost to the period benefited. In the case of a claims-made policy, however, some question whether a straight-line amortization would achieve that matching, as occurrences in the early part of the year are normally more likely to result in a claim by year-end (and thus are covered by the policy) than occurrences later in the year. Accordingly, some believe that an accelerated method of amortization achieves a better matching of costs to the interim period benefited. The method selected should be appropriate in light of the relevant facts and circumstances and consistently applied.

significant adjustments of the estimated year-end IBNR liability.

e. For any insurance recoverable recognized, either related to the IBNR liability or to a specific incurred claim, the entity should evaluate those assets and adjust them, if necessary, based on changes in circumstances. Paragraphs 140 and 141 of SOP 96-1 provide further guidance on the recognition of a receivable for expected insurance recoveries.

f. Any unusual claims and incidents that have been incurred prior to the end of an interim period but will probably be reported prior to year-end should not affect net income if they will be covered (insured) under the existing claims-made insurance policy. However, both the asset (under the insurance claim) and the liability (for the incident) will be reflected on the balance sheet.

20. The Task Force observed that unless the conditions of Interpretation 39 are met, offsetting prepaid insurance and receivables for expected insurance recoveries against a recognized IBNR liability (or the claim liability incurred as a result of a reported event) would not be appropriate.

21. Examples to illustrate the application of this consensus are included in Exhibit 03-8B.

Issue 4(b)—The accounting ramifications on the consensus reached in Issue 4(a) of having a claims-made policy term that does not coincide with the enterprise's fiscal year.

22. The Task Force reached a consensus that when the enterprise's fiscal year and policy year do not coincide, the insurance premium component of the overall IBNR expense in interim periods could be based on the estimated premium for claims-made coverage that the enterprise expects to be able to acquire later in the fiscal year.

23. When the enterprise's fiscal year and policy term do not coincide, an enterprise should recognize three elements at year-end: (a) an IBNR liability related to the enterprise's obligation for claims and incidents that have been incurred prior to year-end but will be reportable after year-end, (b) an insurance recoverable for any outstanding claims that are reimbursable under the existing claims made policy, and (c) an asset for prepaid insurance premiums related to the coverage for claims and incidents that will be incurred after year-end but reported prior to the expiration of the existing claims-made policy. The approach for accounting by policyholders who purchase claims-made insurance policies that have terms of duration that do not coincide with the enterprise's fiscal year is as follows:

a. At the beginning of the fiscal year the enterprise should make an estimate of its future premium cost of the new claims-made policy that is expected to be purchased during the fiscal year. The enterprise should also estimate the portion of that future premium cost that would relate to coverage for claims and incidents that will be incurred after the end of the fiscal year but reported prior to the expiration of that new claims-made policy; that portion represents the estimated prepaid asset at the end of the fiscal year. The estimate of the future premium cost involves estimating the effect of past claims and incidents that are expected to affect the premium level, as well as the effect of historical patterns and any new factors (such as a major change in products, manufacturing processes, or risk management systems) that are relevant.

b. At the beginning of the fiscal year the enterprise should make an estimate of its IBNR liability as of the end of the fiscal year. That estimate involves estimating the claims and incidents that will be incurred prior to year-end but will not be reportable until after the year-end. Presumably the estimated year-end IBNR liability would closely approximate the beginning IBNR liability adjusted for relevant historical patterns unless the enterprise has identified new factors (such as a major change in products, manufacturing processes, or risk management systems) that warrant further adjustment of the ending IBNR liability.

c. The enterprise should compute an estimated annual expense as the sum of (1) the balance of the premium cost for the claims-made policy expiring during the year, (2) the estimated future premium cost for the new claims-made policy, (3) the difference between the beginning IBNR liability and the estimated year-end IBNR liability, and (4) the difference between the beginning and estimated ending insurance receivable related to IBNR. That estimated annual expense should be recognized ratably in interim periods based on the methodology that best reflects the manner in which the benefits of the insurance premiums are consumed and the IBNR liability is incurred.[7] In addition, liabilities for specific claims incurred during the year that are not included in the IBNR estimate should be recognized as expense in the period in which they are incurred.

d. The estimated year-end IBNR liability should be reviewed whenever interim financial statements are prepared. Routine adjustments in the estimated liability (such as adjusting the estimated future premium cost to reflect actual) would be recognized ratably in each of the remaining interim periods. However, if events and circumstances in that interim period indicate that unusual claims and incidents have been incurred prior to the end of the interim period, the enterprise should recognize in that interim period any related significant adjustments of the estimated year-end IBNR liability.

e. For any insurance recoverable recognized, either related to the IBNR liability or to a specific incurred claim, the entity should evaluate those assets and adjust them, if necessary, based on changes in circumstances. Paragraphs 140 and 141 of SOP 96-1 provide further guidance on the recognition of a receivable for expected insurance recoveries.

f. Any unusual claims and incidents that have been incurred prior to the end of an interim period and that will probably be reported prior to expiration of the new claims-made insurance policy should not affect net income if they will be covered by insurance. However, both the asset (under the insurance claim) and the liability (for the incident) will be reflected on the balance sheet.

24. The Task Force observed that unless the conditions of Interpretation 39 are met, offsetting prepaid insurance and receivables for expected insurance recoveries against a recognized IBNR liability (or the claim liability incurred as a result of a reported event) would not be appropriate.

25. Examples to illustrate the application of this consensus are included in Exhibit 03-8C.

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[7] Refer to footnote 6.

Issue 5—Disclosures that should be made by companies insured under claims-made policies.

25. The Task Force discussed what disclosures would be appropriate when an enterprise changes from occurrence-based insurance to claims-made insurance or elects to significantly reduce or eliminate its insurance coverage. Members of the Task Force noted that paragraph 10 of Statement 5 requires disclosure if it is at least reasonably possible that a loss has been incurred. That paragraph also discusses disclosure with respect to unasserted claims.

26. In July 1987, the AICPA issued the Report of the Task Force on Disclosure of Insurance, *Disclosure Concerning Insurance Coverage*. That report encouraged publicly held entities and entities with public accountability, such as governments, to disclose circumstances in which they are exposed to certain uninsured risks of future material loss. The report indicates that each reporting entity should decide the matters to be disclosed, depending on its circumstances. The report does not recommend any specific disclosures that would be appropriate when an entity changes from occurrence-based insurance to claims-made insurance or elects to reduce significantly or eliminate its insurance coverage.

27. The Task Force Report issued in 1987 may no longer be retrievable. Therefore, the conclusions reached by AcSEC have been provided below.

> In its Statement No. 5, the FASB said that it did not discourage disclosure of uninsured risks in appropriate circumstances. AcSEC believes that, though operational criteria have not been developed for such disclosures as stated in Statement No. 5, they should be encouraged rather than simply not discouraged. Accordingly, AcSEC reached the following conclusions:
>
> 1. Publicly held entities and entities with public accountability, such as governments, are encouraged, but not required, to disclose circumstances in which
>
>   a. They are exposed to risks of future material loss related to
>
>   i. Torts,
>   ii. Theft of, damage to, expropriation of, or destruction of assets,
>   iii. Business interruption
>   iv. Errors or omissions,
>   v. Injuries to employees, or
>   vi. Acts of God, and
>
>   b. Those risks have not been transferred to unrelated third parties through insurance.
>
> 2. Each reporting entity should decide the matters to be disclosed, depending on its circumstances. A standard form of disclosure is therefore not recommended. The following are some of the matters reporting entities

might consider for disclosure:

a. The actual and potential effects of losses from such risks on the entity's historical or planned operations, including exposure to losses from claims, curtailment of research and development or manufacturing, or contraction or cessation of other activities, such as discontinuance of a product line

b. Comparison of current insurance coverage by major categories of risk to coverage in prior periods, without necessarily quantifying such coverage or change in coverage

c. Recent claims experience

d. A description of the reporting entity's risk management programs.

3. Disclosure of this kind is experimental. Its location in a financial report therefore depends on the judgment of those preparing the financial report.

TRANSITION

28. The Task Force observed that the transition guidance for the above issues is governed by the original consensuses on those issues.

STATUS

29. No further EITF discussion is planned.

Exhibit 03-8A

EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUS ON ISSUE 2 OF ISSUE 03-8

Example 1

Company ABC is a manufacturer that purchases D&O insurance under a claims-made insurance policy each year. Company ABC immediately reports any asserted claims or incidents that could result in an asserted claim to its insurance carrier. Company ABC currently has no knowledge of any unasserted claims against it. Further, Company ABC is unaware of any event that would result in any claims. Company ABC considers the use of a claims-made insurance policy to be the most efficient and least costly method available to manage its insurance risk related to suits against its directors and officers. Company ABC pays BrokerCo to handle its insurance needs. BrokerCo supplies Company ABC with binding quotes from several insurance carriers and a comparison to binding quotes for other similar companies. Company ABC believes that its premiums are comparable to those of other similar entities that have similar insurance risk profiles and no knowledge of any events or circumstances that might result in a claim. Company ABC has an option to purchase tail-coverage, which would effectively convert its claims-made policies into occurrence-based policies at any time. On January 1, 20X3, Company ABC pays its annual premium of $5 million for its policy. The policy has a retroactive date to January 1, 20X0, which is the year that Company ABC first started using the claims-made insurance approach with its insurance carrier. Company ABC is unable to bifurcate its policy premium into its retroactive and prospective provisions.

In June 20X3, there is a precipitous drop in the stock price of Company ABC, and a lawsuit is brought against the directors of Company ABC. Company ABC notifies its insurer about the asserted claim, and the insurer agrees that those claims are covered by its claims-made policy in effect for 20X3.

Evaluation: Company ABC determined in 20X0 that its claims-made insurance policy is a prospective contract that does not contain any retroactive provisions. Essentially, Company ABC was unaware of any known events or circumstances that might result in a claim and viewed the premiums paid for its D&O insurance as providing coverage against claims that might occur during the policy period. In making its determination that the claims-made insurance policy did not contain a retroactive provision, Company ABC also considered the following:

- Company ABC typically uses a claims-made policy to manage its insurance risk and plans to continue purchasing a claims-made insurance policy annually.
- Tail coverage is readily available.
- The premium charged for the claims-made policy is not significantly in excess of premiums charged to other similar entities with similar insurance profiles.

- The claims-made policy contains an unambiguous contract trigger to determine when claims are covered.

- Because Company ABC has no knowledge of any asserted claims or events that would result in a claim, the claims-made policy is primarily expected to cover insurance risk related to future claims.

Example 2

Same facts as Example 1, except that the precipitous drop in the stock price of Company ABC occurred in 19X9, prior to the inception of Company ABC's claims-made insurance program with its insurance carrier. During the negotiation of the contract premium, Company ABC discussed its concerns with its insurance carrier, and the two agreed that the retroactive date would include any claims related to the drop in the stock price. As a result, the premium was $50 million.

Evaluation: Company ABC determined in 20X0 that its claims-made insurance policy contains a retroactive provision. Company ABC knows that the $50 million premium charged represents the expected costs of settling any claims related to the drop in its stock price, an event that was fully known at the inception of the contract. Company ABC disclosed this fact to its insurer, and the two agreed that it might result in a claim and negotiated a premium based on that premise. In making its determination that its D&O policy contains a retroactive provision, Company ABC also considered the following:

- The claims-made policy was taken out in part in response to a known incident that was reported to the insurer.

- The premium charged by the insurer includes an estimate of the expected settlement costs for the unasserted claim.

- The premium charged primarily represents a financing of the unasserted claim.

Prior to accounting for the entire contract retroactively, Company ABC should, if practicable, bifurcate the contract into its retroactive and prospective provisions and account for each separately.

Example 3

On February 20, 20X2, Company XYZ determined that it needed to recognize a $100 million liability for environmental contamination as a result of an accident at one of its manufacturing plants. Company XYZ initially believed that it would manage the cleanup and any lawsuits arising from the accident through an internal self-insurance program. Subsequently, Company XYZ decided to purchase a claims-made insurance policy that would include all claims arising from the incident. Company XYZ decided that it should purchase the policy because (a) it would be more efficient to transfer the risk associated with the development and timing of claims to a third party and (b) representing that the risk associated with all claims had been transferred to a third party would reduce the risk profile of the Company to its shareholders and other potential investors. On April 1, 20X2, Company XYZ pays InsurerCo $60 million for a claims-made insurance policy. Company XYZ and InsurerCo expect the claims related to the incident to be settled over a 10-year period after the purchase of the policy.

Evaluation: Based on an evaluation of the indicators, Company XYZ determines that its claims-made insurance policy contains a retroactive provision. In making that determination, Company XYZ specifically considered the following:

- The claims-made policy was purchased specifically to cover known claims for which a liability had been recognized.

- The claims-made policy effectively represented a financing of the liability previously recognized by Company XYZ.

- The premium charged was primarily based on expected payouts for an event that has already occurred.

Example 4

HealthCo is a health care provider that purchases medical malpractice insurance in order to manage its insurance risks. HealthCo purchases a claims-made insurance policy each year from its insurance carrier. HealthCo would be able to purchase tail-coverage from its insurance carrier if it chose to do so. Although HealthCo has no knowledge of any asserted or unasserted claims against it, HealthCo estimates and recognizes a liability for claims incurred but not reported of $25 million at December 31, 20X2, based on actuarial reviews of its historical claims reporting and payment patterns. HealthCo engages an insurance brokerage firm to ensure that its insurance premiums are consistent with those offered to similar companies with similar insurance risks. During 20X2, HealthCo paid out $95 million of malpractice claims that were fully covered by its insurance program. On January 1, 20X3, HealthCo pays its annual premium of $100 million for its claims-made policy. HealthCo expects that it will require a liability of $29 million on December 31, 20X3. The policy does not cover incidents occurring prior to the inception of the claims-made insurance program with that insurance carrier. In negotiating its policy with InsurerCo, HealthCo asserts to InsurerCo that it is unaware of any specific, current claims (asserted or unasserted) against it.

Evaluation: Based on an evaluation of the indicators, HealthCo determines that its claims-made insurance policy is a prospective contract that does not contain any retroactive provisions. In making that determination, HealthCo specifically considered the following:

- There are no known asserted or unasserted claims that are expected to be covered by the policy. The liability recognized for IBNR claims would not preclude HealthCo from concluding that its claims-made insurance policy is prospective as the Company represented that it did not know of any asserted claims.

- Tail coverage is readily available.

- The premium charged for the claims-made policy is not significantly in excess of premiums charged for similar policies with no retroactive dates.

- There is a clear and unambiguous contract coverage trigger.

Exhibit 03-8B

EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUS ON ISSUE 4(a) OF ISSUE 03-8

Example 1

Assumed Facts:

- XYZ Company purchases claims-made policies every year for its insurable risk. The insurance arrangement meets the criteria for prospective treatment as described in Issue 03-8. The policy has a $500,000 per incident deductible and a $2 million per incident maximum with a policy limit of $15 million. When calculating the insurance recoverable related to IBNR incidents, XYZ assumes that approximately 50 percent of the gross claim value will be recovered because of the deductible. XYZ does not anticipate incurring any losses in excess of the policy's maximums.

• Accrued IBNR liability at 12/31/X0.	$2 million
• Receivable for insurance recoverable at 12/31/X0.	$1 million
• Estimated IBNR liability at 12/31/X1.	$2.2 million
• Estimated receivable for insurance recoverable at 12/31/X1.	$1.1 million
• Premium for claims-made policy for year ending 12/31/X1, payable 1/1/X1.	$1.6 million
• Value of claim for an incident reported during the second quarter.[8]	$750,000

Computations (in thousands):

Expected annual expense	=	annual premium + expected increase in IBNR liability − expected increase in insurance recoverable
	=	$1,600 + ($2,200 − $2,000) − ($1,100 − $1,000)
	=	$1,600 + $200 − $100
	=	$1,700
Expected quarterly expense	=	$1,700 ÷ 4 = $425

IBNR Liability[9] (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Balance, beginning of quarter	$(2,000)	$(2,050)	$(2,100)	$(2,150)
Add: accrual[10]	(50)	(50)	(50)	(50)
Balance, end of quarter	$(2,050)	$(2,100)	$(2,150)	$(2,200)

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[8] The claim is covered by the insurance policy subject to a $500,000 deductible and was both paid to the claimant and recovered from the carrier during the third quarter.

[9] Interpretation 39 was issued in March 1992 and provides additional guidance on when the legal right to setoff exists and should be used to determine whether prepaid insurance (or insurance recoverable) and a recognized IBNR liability (or the claim liability incurred as a result of a reported event) may be offset. Such offsetting would not be appropriate unless the conditions of Interpretation 39 are met. For income statement purposes, however, the expenses related to claims reported and the income related to insurance recoverables may be offset.

[10] Straight-line accrual of the IBNR liability is assumed for purposes of simplicity but would only be appropriate if management expected that the underlying IBNR claims covered by the insurance arrangement would occur evenly throughout the year. Refer to paragraph 19(c).

Known Claims Liability (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Balance, beginning of quarter	$ –	$ –	$ (750)	$ –
Add: claims made	–	(750)	–	–
Less: claims paid	–	–	750	–
Balance, end of quarter	$ –	$ (750)	$ –	$ –

Prepaid Insurance (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Balance, beginning of quarter	$ –	$1,200	$ 800	$ 400
Add: premium payments made	1,600	–	–	–
Less: amortization[11]	(400)	(400)	(400)	(400)
Balance, end of quarter	$1,200	$ 800	$ 400	$ –

Insurance Recoverable[12] (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Balance, beginning of quarter	$ 1,000	$ 1,025	$ 1,300	$ 1,075
Add: Expected recoveries	25	275	25	25
Less: Recoveries received	–	–	(250)	–
Balance, end of quarter	$ 1,025	$ 1,300	$ 1,075	$ 1,100

Quarterly Expense (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Amortization of prepaid insurance	$ 400	$ 400	$ 400	$ 400
Accrual of IBNR liability	50	50	50	50
Accrued claims reported	–	750	–	–
Accrued insurance recoveries	(25)	(275)	(25)	(25)
Total expense	$ 425	$ 925	$ 425	$ 425

Example 2

Assume the same facts as in Example 1, except that (a) the enterprise revises its estimated year-end IBNR liability from $2.2 million to $2.6 million in the second quarter due to overall increases in settling claims, which is considered a routine adjustment by management, and (b) the enterprise determines that a reasonable matching of the additional cost to the periods

[11] Straight-line amortization of the prepaid insurance premium is assumed for purposes of simplicity only. Refer to footnote 6.

[12] Paragraphs 140 and 141 of SOP 96-1 provide further guidance on the recognition of a receivable for expected insurance recoveries.

benefited results in recognizing one-half of the adjustment in the second quarter and the remainder of the adjustment over the remaining interim periods on a pro-rata basis.

IBNR Liability (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Balance, beginning of quarter	$(2,000)	$(2,050)	$(2,300)	$(2,450)
Add: accrual	(50)	(250)	(150)	(150)
Balance, end of quarter	$(2,050)	$(2,300)	$(2,450)	$(2,600)

Known Claims Liability (in thousands):

Same as Example 1.

Prepaid Insurance (in thousands):

Same as Example 1.

Insurance Recoverable (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Balance, beginning of quarter	$ 1,000	$ 1,025	$ 1,400	$ 1,225
Add: Expected recoveries	25	375	75	75
Less: Recoveries received	–	–	(250)	–
Balance, end of quarter	$ 1,025	$ 1,400	$ 1,225	$ 1,300

Quarterly Expense (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Amortization of prepaid insurance	$ 400	$ 400	$ 400	$ 400
Accrual of IBNR liability	50	250	150	150
Accrued claims reported	–	750	–	–
Accrued insurance recoveries	(25)	(375)	(75)	(75)
Total expense	$ 425	$ 1,025	$ 475	$ 475

Example 3

Assume the same facts as in Example 2, except that the enterprise discovers a defect in the manufacturing process in the third quarter and corrects it. The enterprise evaluates whether its IBNR liability warrants adjustment and concludes that an additional $2.1 million liability is needed for claims that are expected to be reported after year-end. The enterprise considers the discovery of the defect to be an unusual event and determines that a reasonable matching of the additional cost to the periods benefited results in the entire adjustment being recognized in the third quarter.

IBNR Liability (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Balance, beginning of quarter	$(2,000)	$(2,050)	$(2,300)	$(4,550)
Add: accrual	(50)	(250)	(2,250)	(150)
Balance, end of quarter	$(2,050)	$(2,300)	$(4,550)	$(4,700)

Known Claims Liability (in thousands):

Same as Example 1.

Prepaid Insurance (in thousands):

Same as Example 1.

Insurance Recoverable (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Balance, beginning of quarter	$ 1,000	$ 1,025	$ 1,400	$ 2,275
Add: Expected recoveries	25	375	1,125	75
Less: Recoveries received	–	–	(250)	–
Balance, end of quarter	$ 1,025	$ 1,400	$ 2,275	$ 2,350

Quarterly Expense (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Amortization of prepaid insurance	$ 400	$ 400	$ 400	$ 400
Accrual of IBNR liability	50	250	2,250	150
Accrued claims reported	–	750	–	–
Accrued insurance recoveries	(25)	(375)	(1,125)	(75)
Total expense	$ 425	$ 1,025	$ 1,525	$ 475

Exhibit 03-8C

EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUS ON ISSUE 4(b) OF ISSUE 03-8

Example 1

Assumed Facts:

- XYZ Company purchases claims-made policies every year for its insurable risk. The insurance arrangement meets the criteria for prospective treatment as described in Issue 03-8. The policy has a $500,000 per incident deductible and a $2 million per incident maximum with a policy limit of $15 million. When calculating the insurance recoverable related to IBNR incidents, XYZ assumes that approximately 50 percent of the gross claim value will be recovered because of the deductible. XYZ does not anticipate incurring any losses in excess of the policy's maximums.
- The policy period runs from May 1 to April 30, and XYZ uses a December 31 year-end for financial reporting purposes.
- Accrued IBNR liability at 12/31/X0. $2 million
- Receivable for insurance recoverable at 12/31/X0. $1 million
- Estimated IBNR liability at 12/31/X1. $2.2 million
- Estimated receivable for insurance recoverable at 12/31/X1. $1.1 million
- Premium for one-year claims-made policy expiring 4/30/X1. $1.2 million
- Estimated premium for one-year claims-made policy commencing 5/1/X1. $1.8 million
- Value of claim for an incident reported during the second quarter.[13] $750,000

Computations (in thousands):

Expected annual expense = premium costs + expected increase in IBNR liability − expected increase in insurance recoverable

= {[$1,200 × (4/12)] + [$1,800 × (8/12)]} + ($2,200 − $2,000) − (1,100 − 1,000)

= ($400 + 1,200) + $200 − $100

= $1,700

Expected quarterly expense = $1,700 ÷ 4 = $425

IBNR Liability (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Balance, beginning of quarter	$(2,000)	$(2,050)	$(2,100)	$(2,150)
Add: accrual	(50)	(50)	(50)	(50)
Balance, end of quarter	$(2,050)	$(2,100)	$(2,150)	$(2,200)

---

[13] The claim is covered by the insurance policy subject to a $500,000 deductible and was both paid to the claimant and recovered from the carrier during the third quarter.

Known Claims Liability (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Balance, beginning of quarter	$ –	$ –	$ (750)	$ –
Add: claims made	–	(750)	–	–
Less: claims paid	–	–	750	–
Balance, end of quarter	$ –	$ (750)	$ –	$ –

Prepaid Insurance (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Balance, beginning of quarter	$ 400	$ –	$ 1,400	$ 1,000
Add: premium payments made	–	1,800	–	–
Less: amortization	(400)	(400)	(400)	(400)
Balance, end of quarter	$ –	$ 1,400	$ 1,000	$ 600

Insurance Recoverable (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Balance, beginning of quarter	$ 1,000	$ 1,025	$ 1,300	$ 1,075
Add: Expected recoveries	25	275	25	25
Less: Recoveries received	–	–	(250)	–
Balance, end of quarter	$ 1,025	$ 1,300	$ 1,075	$ 1,100

Quarterly Expense (in thousands):

	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Amortization of prepaid insurance	$ 400	$ 400	$ 400	$ 400
Accrual of IBNR liability	50	50	50	50
Accrued claims reported	–	750	–	–
Accrued insurance recoveries	(25)	(275)	(25)	(25)
Total expense	$ 425	$ 925	$ 425	$ 425

Issue No. 03-9

Title: Interaction of Paragraphs 11 and 12 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, Regarding Determination of the Useful Life and Amortization of an Intangible Asset

Dates Discussed: July 31, 2003; November 12–13, 2003

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

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

Introduction

1. The useful life of an intangible asset is defined in Appendix F of Statement 142 as follows:

> The period over which an asset is expected to contribute directly or indirectly to future cash flows.

2. Paragraph 11 of Statement 142 provides the following guidance for estimating the useful life of an intangible asset:

> The accounting for a recognized intangible asset is based on its useful life to the reporting entity. An intangible asset with a finite useful life is amortized; an intangible asset with an indefinite useful life is not amortized. The useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity.[9] The estimate of the useful life of an intangible asset to an entity shall be based on an analysis of all pertinent factors, in particular:
>
> a. The expected use of the asset by the entity
> b. The expected useful life of another asset or a group of assets to which the useful life of the intangible asset may relate (such as mineral rights to depleting assets)
> c. Any legal, regulatory, or contractual provisions that may limit the useful life
> d. Any legal, regulatory, or contractual provisions that enable renewal or extension of the asset's legal or contractual life without substantial cost (provided there is evidence to support renewal or extension and renewal or extension can be accomplished without material modifications of the existing terms and conditions)
> e. The effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing regulatory environment, and expected changes in distribution channels)
> f. The level of maintenance expenditures required to obtain the expected future cash flows from the asset (for example, a material level of required

maintenance in relation to the carrying amount of the asset may suggest a very limited useful life).[10]

If no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset shall be considered to be indefinite. The term *indefinite* does not mean infinite. Appendix A includes illustrative examples of different intangible assets and how they should be accounted for in accordance with this Statement, including determining whether the useful life of an intangible asset is indefinite.

[9] The useful life of an intangible asset shall reflect the period over which it will contribute to the cash flows of the reporting entity, not the period of time that it would take that entity to internally develop an intangible asset that would provide similar benefits.

[10] As in determining the useful life of depreciable tangible assets, regular maintenance may be assumed but enhancements may not.

3. In applying the guidance in paragraph 11, questions have arisen in practice as to how the pertinent factors in paragraph 11(d) should be interpreted and applied. In particular, those questions surround the evaluation of "substantial cost" and "material modifications" in determining whether or not an intangible asset has an indefinite useful life and, if not, the appropriate useful life for the intangible asset. Statement 142 provides only limited guidance on how to apply those concepts—by way of illustrative examples and some discussion in its basis for conclusions.

4. The concepts of *useful life* and *fair value* of an intangible asset, from an economic standpoint, are inextricably linked. Statement 141 and Statement 142 both indicate that the useful life of an intangible asset is related to the period over which the asset is expected to generate cash flows. In some cases, however, the guidance in Statement 142 regarding *useful life* appears to be more restrictive than the guidance provided in Statement 141 with respect to considering the period over which an intangible asset is likely to contribute to an entity's cash flows for the purpose of determining the intangible asset's fair value.

5. On the one hand, paragraph B46 of Statement 142 indicates that the useful life of an intangible asset that is based on legal or contractual rights is constrained by the duration of those legal or contractual rights. Therefore, the useful life cannot extend beyond the expiration of the legal rights. However, the Board also acknowledged, in paragraph B47, that certain intangible assets may be routinely renewed at little or no cost (that is, without substantial cost) and that marketplace transactions often indicate that renewal is implied in the value of certain intangible assets. For those types of assets, the useful life is not necessarily limited to the legal or contractual life. On the other hand, the guidance in paragraph B174 of Statement 141 (in the context of initial recognition of intangible assets) appears to permit, or perhaps even require, a more expansive view of useful life of an intangible asset by indicating that judgment is required in determining the period over which cash flows should be expected for purposes of determining the fair value of an intangible asset. Estimates should incorporate assumptions that marketplace participants would use in making estimates of fair value, such as assumptions about future contract renewals. In cases in which contractual or legal rights are routinely renewed, estimates of future cash flows should extend beyond the remaining contractual or legal term. Statement

141 does not limit the consideration of renewal to only those cases in which renewal can be effected with little or no cost.

6. The relevant examples in Appendix A of Statement 142 (Examples 4–6) provide only limited insight into this question because the examples assume that minimal costs are involved in renewal and that there will be no change to the terms of the arrangements. Furthermore, those examples generally illustrate the distinction between assets with a finite life limited to the contractual period and those with an indefinite life. There is no illustration of how to evaluate situations in which the life may be greater than the contractual life but not indefinite. Because many contractual arrangements or legal rights may be renewed, the issue of determining when such renewal is deemed to occur "without substantial cost" or "without material modification to the terms and conditions" is particularly relevant in assessing the useful life and, in turn, the fair value of intangible assets.

7. In addressing those issues, the FASB staff noted that it is important to consider the interaction of paragraphs 11(c) and 11(d) of Statement 142. Paragraph 11(c) requires consideration of legal or contractual *limits* to the useful life of an intangible asset, whereas paragraph 11(d) addresses situations in which the existing terms and conditions underlying the intangible asset *enable* renewal of the right giving rise to the intangible asset and that, *provided that evidence of renewal exists*, warrant consideration of a useful life that is greater than the existing contractual or legal life. Specifically, whether the *substantial cost* or *material modification* questions will need to be considered is only relevant if evidence of renewal exists.

Issue

8. The issues are:

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

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

Prior EITF Discussion

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

10. Task Force members noted that, in many cases, the fair value of the intangible asset is determined using probability-weighted expected future cash flows and, therefore, it may be difficult to discern a single point estimate for the useful life for amortization purposes. Some

Task Force members also observed that it also may be difficult to differentiate an intangible asset with a relatively long, but *finite*, life from an intangible asset with an *indefinite* life. In the course of that discussion, some Task Force members also noted that linking the amortization period to the estimated useful life considerations used in the valuation model may indicate that straight-line amortization does not best reflect the pattern in which the economic benefits of the intangible asset are consumed. The Task Force directed the FASB staff to further explore these issues for discussion at a future meeting.

11. The Task Force did not discuss Issue 2.

Current EITF Discussion

12. At the November 12–13, 2003 EITF meeting, the Task Force considered an example fact pattern that was prepared by the FASB staff along with various valuation scenarios that were designed to illustrate the application of the "pattern-of-economic-benefit" amortization method for renewable intangible assets. Those illustrations indicate that for the same intangible asset, depending on the pattern of economic benefits implied by the valuation of the asset, the amount and timing of the amortization of the cost of the asset could be dramatically different. However, the FASB staff believes that such a result is consistent with the provisions of paragraph 12 of Statement 142, which states, in part:

> The method of amortization shall reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method shall be used.

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

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

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

Status

16. Further discussion is expected at a future meeting.

Issue No. 03-10

Title: Application of EITF Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor," by Resellers to Sales Incentives Offered to Consumers by Manufacturers

Dates Discussed: July 31, 2003; November 12–13, 2003

Introduction

1. Under Issue 1 of EITF Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor," cash consideration received by a customer from a vendor is presumed to be a reduction of the prices of the vendor's products or services and should, therefore, be characterized as a reduction of cost of sales when recognized in the customer's income statement. However, that presumption is overcome when the consideration is either (a) a payment for assets or services delivered to the vendor, in which case the cash consideration should be characterized as revenue (or other income, as appropriate) when recognized in the customer's income statement, or (b) a reimbursement of costs incurred by the customer to sell the vendor's products, in which case the cash consideration should be characterized as a reduction of that cost when recognized in the customer's income statement.

2. Manufacturers often sell their products to resellers who then sell those products to consumers or other end users. In some cases, manufacturers will offer sales discounts and incentives directly to consumers—for example, coupons—in order to stimulate consumer demand for their products. Because the reseller has direct contact with the consumer, the reseller may agree to accept, at the point of sale to the consumer, the manufacturer's incentives that are tendered by the consumer (for example, honoring manufacturer's coupons as a reduction to the price paid by consumers and then seeking reimbursement from the manufacturer). In other instances the consumer purchases the product from the reseller but deals directly with the manufacturer related to the manufacturer's incentive or discount (for example, mail-in rebates).

3. Although the reseller often benefits from the vendor's direct-to-consumer incentives as a result of increased sales volume, the reseller generally has no control over which consumers or consumer groups participate in the incentive programs. Because the manufacturer reimburses the reseller for the value of the discount provided to the consumer, the reseller's gross margin on the product is the same regardless of whether the consumer purchases the product with the manufacturer's incentive.

4. The following example is used to illustrate the issue presented:

> Manufacturer sells cereal to Reseller for distribution to consumers. Manufacturer charges Reseller $3.00 per box. Reseller offers the product to consumers at a price of $4.00. Manufacturer also offers coupons to consumers, and those coupons are distributed weekly in the newspaper. The coupons offer a 50-cent discount on the purchase of a box of cereal.

When a consumer purchases cereal without the coupon, the Reseller receives $4.00 from the consumer. If a consumer tenders a coupon when purchasing the cereal, the Reseller receives $3.50 from the consumer; the Reseller then remits the coupons to a clearinghouse that handles the Manufacturer's coupons and receives 50-cents for each coupon (exclusive of any handling fee).

Issue

5. The issue is whether consideration received by a reseller from a vendor that is a reimbursement by the vendor for honoring the vendor's sales incentives offered directly to consumers should be recorded as a reduction of the cost of the reseller's purchases from the vendor and, therefore, characterized as a reduction of cost of sales under the guidance in Issue 02-16. For purposes of this Issue, the phrase *vendor's sales incentive offered directly to consumers* is limited to a vendor's incentive (a) that can be tendered by a consumer at resellers that accept manufacturers' incentives in partial (or full) payment of the price charged by the reseller for the vendor's product, (b) for which the reseller receives a direct reimbursement from the vendor (or a clearinghouse authorized by the vendor) based on the face amount of the incentive, (c) that is not part of a broader vendor-reseller-specific incentive program or cooperative promotional program, and (d) whereby the reseller is subject to an agency relationship with the vendor, whether expressed or implied, in the sales incentive transaction between the vendor and the consumer.

Prior EITF Discussion

6. At the July 31, 2003 EITF meeting, the Task Force reached a tentative conclusion that sales incentive arrangements that meet all of the criteria described in paragraph 5 are not subject to the guidance in Issue 02-16. Accordingly, in the example provided in paragraph 4, Reseller would record revenues of $4.00 and cost of sales of $3.00 in accounting for that sale transaction. Sales incentives that do not meet all of the criteria in paragraph 5 are subject to the guidance in EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)," and Issue 02-16, as applicable. Recognizing the possible administrative burden on resellers of segregating one particular form of sales incentive for separate accounting, the Task Force reached a tentative conclusion that resellers should be permitted to report the value of the consideration received for all sales incentive arrangements involving the vendor as a reduction of cost of sales, including the arrangements that meet the criteria in paragraph 5 of this Issue. Therefore, the Task Force also tentatively concluded that disclosure of a company's accounting policy with respect to vendors' sales incentive arrangements should be required.

7. The Task Force instructed the FASB staff to develop a draft abstract reflecting this tentative conclusion and to post it to the FASB website for review and comment.

Current EITF Discussion

8. At the November 12–13, 2003 EITF meeting, the Task Force discussed the comments received on the draft abstract related to the wording in paragraph 5(c) regarding whether the arrangement is part of a broader vendor-reseller-specific incentive program or cooperative

promotional program. The Task Force agreed to amend the wording in paragraph 5(c) to read as follows:

> for which the terms of reimbursement to the reseller for the vendor's sales incentive offered to the consumer must not be influenced by or negotiated in conjunction with any other incentive arrangements between the vendor and the reseller, but, rather, may only be determined by the terms of the incentive offered to the consumer.

9. The Task Force also discussed comments received on the draft abstract related to the sentence in paragraph 6 of the draft abstract that would have allowed resellers to account for all vendor incentive arrangements as reductions in costs of sales, due to the potential administrative burden on resellers resulting from the requirement to segregate certain vendor sales incentives for discrete accounting treatment. Commentators expressed concerns regarding the potential for diversity in financial reporting resulting from that exception, and the Task Force agreed to remove it from the final consensus.

10. In addition to the revisions discussed in paragraphs 8 and 9, the Task Force discussed and agreed to other minor changes to the draft abstract. A marked version of the draft abstract to reflect the changes discussed at the November 12–13, 2003 meeting is attached as Exhibit 03-10A.

11. The Task Force affirmed, as a consensus, the previous tentative conclusion reached at the July 31, 2003 EITF meeting, subject to the changes to paragraph 5(c)—described in paragraph 8—as well as the other changes discussed in paragraphs 9 and 10.

Transition

12. This consensus should be applied to new arrangements, including modifications to existing arrangements, entered into (or, as the case may be, redeemed) in fiscal periods beginning after November 25, 2003. If determinable, pro forma disclosure of the impact of this consensus on prior periods presented is encouraged.

13. Financial statements for prior periods presented for comparative purposes are *permitted* to be restated/reclassified to comply with this consensus, including any necessary restatement of the adoption of Issue 02-16. However, restatement/reclassification is permitted only from the date that Issue 02-16 was originally adopted in a manner consistent with the original timing and method of adoption of the provisions of Issue 02-16. Restatement of financial statements for years prior to the adoption of the provisions of Issue 02-16 or restatement of the method of adoption of Issue 02-16 is not permitted.

14. The following example illustrates the application of the transition provisions.

> **Example**
> Retailer ABC has a January 31 fiscal year-end. In adopting the provisions of Issue 02-16, Retailer ABC recognized a cumulative effect of adoption on February 1, 2002, and

accounted for certain sales incentives under Issue 02-16 for the fiscal year ended January 31, 2003. The Task Force consensus is ratified by the Board on November 25, 2003.

Evaluation

Retailer ABC would apply the provisions of Issue 03-10 prospectively beginning February 1, 2004. In preparing comparative financial statements for the fiscal year ending January 31, 2005, Retailer ABC would have the option of restating/reclassifying its financial statements for the fiscal years ended January 31, 2004 and 2003, including the cumulative effect adjustment related to the adoption of Issue 02-16 recognized on February 1, 2002 (to the extent that the adjustment would have been impacted by the consensus in Issue 03-10). Financial statements for the fiscal year ended January 31, 2002, would not be permitted to be restated/reclassified.

Board Ratification

15. At its November 25, 2003 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

Status

16. No further EITF discussion is planned.

Exhibit 03-10A

Draft Abstract Marked for Changes

EITF ABSTRACTS

Issue No. 03-10

Title: Application of Issue No. 02-16 by Resellers to Sales Incentives Offered to Consumers by Manufacturers

Dates Discussed: July 31, 2003; November 12–13, 2003

ISSUE

1. Under Issue 1 of Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor," cash consideration received by a customer from a vendor is presumed to be a reduction of the prices of the vendor's products or services and should, therefore, be characterized as a reduction of cost of sales when recognized in the customer's income statement. However, that presumption is overcome when the consideration is either (a) a payment for assets or services delivered to the vendor, in which case the cash consideration should be characterized as revenue (or other income, as appropriate) when recognized in the customer's income statement, or (b) a reimbursement of costs incurred by the customer to sell the vendor's products, in which case the cash consideration should be characterized as a reduction of that cost when recognized in the customer's income statement.

2. Manufacturers often sell their products to resellers who then sell those products to consumers or other end users. In some cases, manufacturers will offer sales discounts and incentives directly to consumers—for example, ~~rebates or~~ coupons—in order to stimulate consumer demand for their products. Because the reseller has direct contact with the consumer, the reseller may agree to accept, at the point of sale to the consumer, the manufacturer's incentives that are tendered by the consumer (for example, honoring manufacturer's coupons as a reduction to the price paid by consumers and then seeking reimbursement from the manufacturer). In other instances the consumer purchases the product from the reseller but deals directly with the manufacturer related to the manufacturer's incentive or discount (for example, a mail-in rebate).

3. Although the reseller often benefits from the vendor's direct-to-consumer incentives as a result of increased sales volume, the reseller generally has no control over which consumers or consumer groups participate in the incentive programs. Because the manufacturer reimburses the reseller for the value of the discount provided to the consumer, the reseller's gross margin on the product is the same regardless of whether or not the consumer purchases the product with the manufacturer's incentive.

4. The following example is used to illustrate the issue presented:

Manufacturer sells cereal to Reseller for distribution to consumers. Manufacturer charges Reseller $3.00 per box. Reseller offers the product to consumers at a price of $4.00. Manufacturer also offers coupons to consumers, and those coupons are distributed weekly in the newspaper. The coupons offer a 50-cent discount on the purchase of a box of cereal.

When a consumer purchases cereal without the coupon, the Reseller receives $4.00 from the consumer. If a consumer tenders a coupon when purchasing the cereal, the Reseller receives $3.50 from the consumer; the Reseller then remits the coupons to a clearinghouse that handles the Manufacturer's coupons and receives 50-cents for each coupon (exclusive of any handling fee.)

5. The issue is whether consideration received by a reseller from a vendor that is a reimbursement by the vendor for honoring the vendor's sales incentives offered directly to consumers should be recorded as a reduction of the cost of the reseller's purchases from the vendor and, therefore, characterized as a reduction of cost of sales under the guidance in Issue 02-16. For purposes of this Issue, the phrase *vendor's sales incentive offered directly to consumers* is limited to a vendor's incentive (a) that can be tendered by a consumer at ~~any~~ resellers that accept manufacturer's incentives in partial (or full) payment of the price charged by the reseller for the vendor's product, (b) for which the reseller receives a direct reimbursement from the vendor (or a clearinghouse authorized by the vendor) based on the face amount of the incentive, (c) for which the terms of reimbursement to the reseller for the vendor's sales incentive offered to the consumer must not be influenced by or negotiated in conjunction with any other incentive arrangements between the vendor and the reseller but, rather, may only be determined by the terms of the incentive offered to consumers, ~~that is not part of a broader vendor-reseller-specific incentive program or cooperative promotional program,~~ and (d) whereby the reseller is subject to an agency relationship with the vendor, whether expressed or implied, in the sales incentive transaction between the vendor and the consumer.

EITF DISCUSSION

6. The Task Force reached a consensus that sales incentive arrangements that meet all of the criteria described in paragraph 5 are not subject to the guidance in Issue 02-16. Accordingly, in the example provided in paragraph 4, Reseller would record revenues of $4.00 and cost of sales of $3.00 in accounting for that sale transaction. Sales incentives that do not meet all of the criteria in paragraph 5 are subject to the guidance in Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)," and Issue 02-16, as applicable. ~~Recognizing the possible administrative burden on resellers of segregating one particular form of sales incentive for separate accounting, the Task Force agreed to permit resellers to report the value of the consideration received for all sales incentive arrangements involving the vendor as a reduction of cost of sales, including the arrangements that meet the criteria in paragraph 5 of this Issue. Therefore, the Task Force also concluded that disclosure of a company's accounting policy with respect to vendors' sales incentive arrangements should be required.~~

Transition

7. This consensus should be applied to new arrangements, including modifications to existing arrangements, entered into (or, as the case may be, redeemed) in fiscal periods beginning after November 25, 2003. If determinable, pro forma disclosure of the impact of this consensus on prior periods presented is encouraged.

8. Financial statements for prior periods presented for comparative purposes may be restated/reclassified to comply with this consensus, including any necessary restatement of the adoption of Issue 02-16. However, restatement/reclassification is permitted only from the date that Issue 02-16 was originally adopted in a manner consistent with the original timing and method of adoption of the provisions of Issue 02-16. Restatement of financial statements for years prior to the adoption of the provisions of Issue 02-16 or restatement of the method of adoption of Issue 02-16 is not permitted.

9. The following example illustrates that application of the transition provisions.

Example

Retailer ABC has a January 31 fiscal year-end. In adopting the provisions of Issue 02-16, Retailer ABC recognized a cumulative effect of adoption on February 1, 2002, and accounted for certain sales incentives under Issue 02-16 for the fiscal year ended January 31, 2003. The Task Force consensus is ratified by the Board on November 25, 2003.

Evaluation

Retailer ABC would apply the provisions of Issue 03-10 prospectively beginning February 1, 2004. In preparing comparative financial statements for the fiscal year ending January 31, 2005, Retailer ABC would have the option of restating/reclassifying its financial statements for the fiscal years ended January 31, 2004 and 2003, including the cumulative effect adjustment related to the adoption of Issue 02-16 recognized on February 1, 2002 (to the extent that the adjustment would have been impacted by the consensus in Issue 03-10). Financial statements for the fiscal year ended January 31, 2002, would not be permitted to be restated/reclassified.

~~7. This consensus should be applied to the accounting for sales incentives tendered by consumers in fiscal years beginning after December 15, 2003. Early application of the tentative conclusion is not permitted. Reclassification of financial statements for prior periods presented for comparative purposes is not permitted.~~

Board Ratification

10. At its November 25, 2003 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

STATUS

11. No further EITF discussion is planned.

Issue No. 03-12

Title: Impact of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, on EITF Issue No. 95-1, "Revenue Recognition on Sales with a Guaranteed Minimum Resale Value"

Date Discussed: November 12–13, 2003

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

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

SEC Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*

Introduction

1. The Task Force reached a consensus on EITF Issue No. 95-1, "Revenue Recognition on Sales with a Guaranteed Minimum Resale Value," that a manufacturer is precluded from recognizing a sale of equipment if the manufacturer guarantees the resale value of the equipment to the purchaser unless the transaction satisfies the conditions to be classified as a sales-type lease under paragraphs 7 and 8 of Statement 13. For purposes of classifying the lease as an operating lease or a sales-type lease, the consensus states that the minimum lease payments (as defined in paragraph 5 of Statement 13) should be calculated as the difference between the proceeds upon the equipment's initial transfer and the amount of the residual value guarantee to the purchaser as of the first exercise date of the guarantee.

2. The Status section of Issue 95-1 was updated to reflect the issuance of Interpretation 45, which partially nullified Issue 95-1. The effect of that partial nullification is that manufacturers will continue to apply the principles of Statement 13 to transactions within the scope of Issue 95-1 and will continue to apply the provisions of Issue 95-1 in determining "minimum lease payments." However, manufacturers would recognize the fair value of the guarantee in accordance with Interpretation 45 when recording a sales-type lease. The FASB staff has received questions about the appropriateness of that status update. Some constituents have expressed the view that Interpretation 45 should not have affected the consensus in Issue 95-1. Other constituents, who believe that Interpretation 45 should affect Issue 95-1, have expressed differing views as to what that effect should be. Those views can be summarized as follows:

a. The status update appropriately clarifies, for transactions subject to the scope of Issue 95-1, the requirement under Interpretation 45 to recognize the guarantee at fair value. Manufacturers should continue to apply the provisions of Issue 95-1 in determining "minimum lease payments" and the provisions of Statement 13 in evaluating the appropriate classification of the lease; however, the manufacturer should also recognize the fair value of the guarantee when recording a sales-type lease.

b. Interpretation 45 should neither nullify nor partially nullify Issue 95-1 because Interpretation 45 does not apply to a guarantee whose existence prevents the guarantor from being able to account for a transaction as a sale of an asset. In addition, the manufacturer does not recognize the sale of the residual value of the equipment guaranteed by the lessor when recording a sales-type lease; therefore, the manufacturer would not recognize the fair value of the guarantee at lease inception.

c. Interpretation 45 should nullify Issue 95-1 in its entirety. Because Interpretation 45 provides guidance for the initial recognition and measurement of guarantees, there is no need to account for the transaction as a lease. The manufacturer should account for the transaction as the sale of equipment and the issuance of a guarantee, which would be recorded at fair value.

Issue

4. The issue is what effect Interpretation 45 has on the consensus reached in Issue 95-1.

Current EITF Discussion

5. At the November 12–13, 2003 EITF meeting, the Task Force reached a consensus that Interpretation 45 does not affect Issue 95-1 because Interpretation 45 does not apply to a guarantee for which the underlying is related to an asset of the guarantor. Because the manufacturer continues to recognize the residual value of the equipment guaranteed by the manufacturer as an asset (included in the seller-lessor's net investment in the lease) when recording a sales-type lease, that guarantee is not subject to the provisions of Interpretation 45 and, as a result, the accounting prescribed in Issue 95-1 is unaffected by Interpretation 45.

6. Exhibit 03-12A indicates the revised Status section for Issue 95-1 as a result of the Task Force's consensus.

Board Ratification

7. At its November 25, 2003 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

Status

8. No further EITF discussion is planned.

Exhibit 03-12A

EFFECT OF THE CONSENSUS ON ISSUE 95-1

Based on the consensus reached in Issue 03-12, the Status section of Issue 95-1 will be updated as follows (additions are underscored and deletions are scored through):

> Interpretation 45, which was issued in November 2002, requires a guarantor to recognize, at inception of the guarantee, a liability for the obligation undertaken in issuing the guarantee. The Interpretation also elaborates on the disclosures to be made by a guarantor.
>
> Interpretation 45 does not affect this Issue because Interpretation 45 does not apply to a guarantee for which the underlying is related to an asset of the guarantor. Because the manufacturer continues to recognize the residual value of the equipment guaranteed by the manufacturer as an asset (included in the seller-lessor's net investment in the lease) when recording a sales-type lease, that guarantee does not meet the characteristics in paragraph 3 of Interpretation 45 and is, therefore, not subject to the provisions of Interpretation 45. ~~Interpretation 45 partially nullifies this Issue, but only with respect to sales-type leases. Under a sales-type lease, the manufacturer would remove the asset from its books. Thus, the manufacturer would be, in effect, guaranteeing the market value of an asset of the guaranteed party. That type of guarantee is within the scope of the Interpretation under paragraph 3(a). However~~ Additionally, if the lease is classified as an operating lease, the manufacturer does not remove the asset from its books and its guarantee would be a market value guarantee of its own asset. A market value guarantee of the guarantor's own asset is not within the scope of the Interpretation, and the guidance for an operating lease in this Issue is not nullified. As a result, the accounting prescribed in this Issue is unaffected by Interpretation 45.

Issue No. 03-13

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

Date Discussed: November 12–13, 2003

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

Introduction

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Issue

9. The issues are:

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

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

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

Current EITF Discussion

10. At the November 12–13, 2003 EITF meeting, the Task Force discussed the Working Group's proposed approach for assessing whether the criteria in paragraph 42 of Statement 142 have been met for purposes of classifying the results of operations of a component of an entity that either has been disposed of or is classified as held for sale as discontinued operations. That proposed guidance focuses on (a) the cash flows that constitute "cash flows of the component" and (b) the continuing involvement that constitutes significant continuing involvement.

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

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

Status

13. Further discussion is expected at a future meeting.

Issue No. 03-14

Title: Participants' Accounting for Emissions Allowances under a "Cap and Trade" Program

Date Discussed: November 12–13, 2003

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

FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*

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

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

FASB Statement No. 141, *Business Combinations*

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

FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

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

Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*

International Accounting Standard No. 38, *Intangible Assets*

IFRIC Draft Interpretation D1, *Emissions Rights*

Introduction

1. The objective of this Issue is to provide a comprehensive accounting model for participants in a "cap and trade" emissions reduction program. Ultimately, the Issue should address asset recognition, measurement and impairment, cost allocation, liability recognition, presentation (gross verses net), and disclosures. The International Financial Reporting Interpretations Committee (IFRIC) is addressing a similar issue with a similar objective entitled *Emissions Rights.*

2. The following describes a typical "cap and trade" program for emissions reductions.

    A government establishes a target for the amount of emissions during a compliance period. Based on the targeted emissions, the government allocates emissions allowances that give a participant in the plan the right to emit a specified amount of gases (for example, a ton of carbon dioxide). Participation in the program may be voluntary or compulsory. Participants may be allocated allowances free of charge, or they may be required to purchase allowances from the government (for example, through government auctions).

Programs operate over a compliance period, and allowances are allocated (or auctioned) to the participants at the beginning of the compliance period. During the period, participants may buy or sell allowances directly with other participants or, depending on market sophistication, through a broker or on an exchange.

At the end of a compliance period, the participant must deliver emissions allowances equal to its actual emissions. If a participant fails to deliver the required allowances, it may be required to pay fines (or receive a smaller financial incentive) and it may receive a smaller allocation of emissions allowances in the future. In some cases, unused (or excess) allowances may be carried forward to future compliance periods.

For a compliance period, a participant has three options:

- It may emit gases to the level of its allocated allowances
- It may emit gases to a lower level than is represented by the allocated allowances and it may sell or bank the excess allowances
- It may emit gases to a higher level than is represented by the allocated allowances and either buy additional allowances or pay a penalty.

In the extreme, a participant may sell all of its allowances at the beginning of the compliance period with the expectation of either (a) buying allowances to cover emissions at a later date or (b) ceasing gas emissions.

Brokers and other nonparticipants typically may buy and sell emissions allowances. The participation of these other parties may increase the liquidity of the market for the allowances.

Issue

3. The issue is how to account for emissions allowances under a "cap and trade" program. That broad issue is broken down into several specific issues, including:

Issue 1— Whether a participant in a "cap and trade" emissions reduction program should recognize an asset for emissions allowances

Issue 2— If emissions allowances under a "cap and trade" program are assets, the nature of the asset.

Current EITF Discussion

4. At the November 12–13, 2003 EITF meeting, the Task Force decided to remove this Issue from its agenda. Some Task Force members observed that this Issue has implications beyond "cap and trade" emissions programs and that any consensus on this Issue may impact the accounting for other forms of regulation—such as licenses and permits that are granted by governmental authorities. Other Task Force members raised concerns about the prospect of an accounting model that might permit immediate recognition of income upon receipt of the emissions allowances with the costs of complying with the related regulations being recognized

subsequently as an expense. Still other Task Force members observed that they did not perceive a practice issue or diversity in the accounting for emissions trading programs.

Status

5. No further EITF discussion is planned.

Issue No. 03-16

Title: Accounting for Investments in Limited Liability Companies

Date Discussed: November 12–13, 2003

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

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

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

Proposed AICPA Statement of Position, *Accounting for Investor's Interests in Unconsolidated Real Estate Investments*, issued November 2000

Introduction

1. Opinion 18 prescribes the accounting for investments in the common stock of corporations that are not consolidated. Opinion 18 specifies that investments that allow the investor to exercise significant influence over the operating and financial policies of an investee should be accounted for using the equity method. Further, Opinion 18 establishes a presumption of significant influence for investments that represent 20 percent or more of the investee's outstanding voting stock.

2. Interpretation 2 indicates that while Opinion 18 does not apply to partnerships, "many of the provisions of the Opinion would be appropriate in accounting" for partnerships. Although there is no authoritative accounting literature that broadly addresses the accounting for limited partnerships, SOP 78-9 addresses the accounting for real estate partnerships, and that accounting is applied by analogy to partnerships that are not real estate ventures. SOP 78-9 requires noncontrolling investments in limited partnerships (LPs) to be accounted for using the equity method as described in Opinion 18 unless the limited partner's interest is "so minor that the limited partner may have virtually no influence over partnership operating and financial policies . . . . and, accordingly, accounting for the investment using the cost method may be appropriate." In *EITF Abstracts*, Topic No. D-46, "Accounting for Limited Partnership Investments," the SEC staff clarified its view that investments of more than 3 to 5 percent are considered to be more than minor and, therefore, should be accounted for using the equity method. As a result of the above guidance, the accounting for an investment in, for example, 10 percent of the outstanding common stock of a corporation may be accounted for differently than an investment at a similar level in a limited partnership.

3. Limited liability companies (LLCs) have characteristics of both corporations and partnerships but are dissimilar from both in certain respects. The following discussion compares characteristics typical of many LLC structures with characteristics of corporations or partnerships; however, those characteristics may not be present in all LLC structures. Like a corporation, the members (that is, owners) of an LLC generally are not personally liable for the

liabilities of the LLC. However, like a partnership, the members of an LLC—rather than the entity itself—are taxed on their respective shares of the LLC's earnings. Unlike a limited partnership, it is generally not necessary for one owner (for example, the general partner in an LP) to be liable for the liabilities of the LLC. Also, unlike an LP in which the general partner manages the partnership, or a corporation in which the Board of Directors and its Committees control the operations, owners may participate in the management of an LLC. Members may participate in an LLC's management but generally do not forfeit the protection from personal liability afforded by the LLC structure. In contrast, the general partner of a limited partnership has control but also has unlimited liability, whereas the limited partners have limited liability like the members of an LLC. Additionally, all partners in a general partnership have unlimited liability. Like a partnership, financial interests in most LLCs may be assigned only with the consent of all of the LLC members. Like a partnership, most LLCs are dissolved by death, bankruptcy, or withdrawal of a member. Due to these similarities and differences between LLCs and corporations/partnerships, diversity in practice exists with respect to accounting for noncontrolling investments in LLCs.

Issue

4. The issue is whether an LLC should be viewed as similar to a corporation or similar to a partnership for purposes of determining whether a noncontrolling investment in an LLC should be accounted for using the cost method or the equity method of accounting.

Current EITF Discussion

5. At the November 12–13, 2003 EITF meeting, the Task Force reached a tentative conclusion that investments in an LLC that maintains a "specific ownership account" for each investor—similar to a partnership capital account structure—should be viewed as similar to a limited partnership for purposes of determining whether a noncontrolling investment in an LLC should be accounted for using the cost method or the equity method of accounting. Therefore, the provisions of SOP 78-9 and related guidance also would apply to such LLCs. The guidance provided by the SEC staff in Topic D-46 would similarly apply to such LLCs.

6. Specific ownership account structures are described in the AICPA's November 2000 proposed Statement of Position, *Accounting for Investors' Interests in Unconsolidated Real Estate Investments*, as structures in which each owner has a specific ownership account in the entity to which the owner's share of profits and losses, contributions, and distributions accrues directly. In reaching the tentative conclusion, the Task Force observed that specific ownership accounts represent the LLC member's claim to the net assets of the LLC in the same manner that they represent a limited partner's claim on the net assets of an LP.

7. The Task Force asked the FASB staff to further research the various legal structures of LLCs to determine if circumstances exist in which the specific ownership accounts do not represent a claim on the long term appreciation of the LLC, and, therefore, the analogy to partnerships may not be appropriate.

Transition

8. Subject to the further research requested by the Task Force, if the Task Force reaches a consensus based on the tentative conclusion in paragraph 5, the effect of that consensus would be

applied to the accounting for existing investments in LLCs as of the beginning of the first fiscal period beginning after Board ratification of the consensus, by recognizing the cumulative effect of retroactive application.

Status

9. Further discussion is expected at a future meeting.

Issue No. 03-17

Title: Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity's Balance Sheet

Date Discussed: November 12–13, 2003

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

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

FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*

FASB Statement No. 123, *Accounting for Stock-Based Compensation*

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

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

FASB Statement No. 141, *Business Combinations*

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

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

FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*

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

FASB Technical Bulletin No. 79-15, *Accounting for Loss on a Sublease Not Involving the Disposal of a Segment*

Proposed FASB Staff Position No. FIN 45-a, "Whether FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value"

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

AICPA Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*

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

APB Opinion No. 25, *Accounting for Stock Issued to Employees*

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

AICPA Statement of Position 81-1, *Accounting for Performance of Construction-*

Introduction

1. The EITF Agenda Committee received a request to consider an issue regarding the subsequent accounting for an asset arising from an energy contract acquired in a business combination (assuming the energy contract is not a derivative because it meets the definition of a normal purchases and sales contract described in paragraph 10 of Statement 133, as amended). The Agenda Committee agreed that the scope of the issue should be extended to address the subsequent accounting of all assets and liabilities arising from executory contracts that are recognized on a company's balance sheet. This Issue will not address questions about the initial recognition and measurement of assets and liabilities arising from executory contracts.

2. Authoritative accounting literature does not provide comprehensive guidance on the recognition and measurement of assets and liabilities arising from executory contracts. For purposes of this Issue, an executory contract is a contract that remains wholly unperformed or for which there remains something to be done by either or both parties of the contract.

3. The Task Force previously addressed, without reaching a consensus, the issue of when a buyer and seller under a firmly committed[1] executory contract should recognize and measure an impairment of their remaining contractual right to receive goods or services (buyer) or contractual obligation to deliver goods or services (seller) under EITF Issues No. 99-14, "Recognition by a Purchaser of Losses on Firmly Committed Executory Contracts," and No. 00-26, "Recognition by a Seller of Losses on Firmly Committed Executory Contracts." In November 2002, the Task Force removed both of those Issues from its agenda due to the broad nature of the topic and significant implications on financial reporting. However, the Task Force requested that the FASB staff explore the possibility of a Board project. In December 2002, the Board deferred consideration of the accounting for executory contracts.

4. This Issue does not address the subsequent accounting for rights and obligations arising from executory contracts that have been recognized as assets and liabilities that are addressed by existing authoritative literature, such as (a) derivatives accounted for under Statement 133, as amended, (b) financial assets and financial liabilities, as defined by and accounted for under Statement 140, (c) employee compensation accounted for under Statements 87, 106, 123, and Opinion 25, and (d) costs associated with exit or disposal activities accounted for under Statement 146. The subsequent accounting for assets and liabilities arising from revenue

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[1] Issue 99-14 and Issue 00-26 defined the term *firm commitment* using the definition from paragraph 540 of Statement 133:

> An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:
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> a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield.
>
> b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable.

transactions is beyond the scope of this Issue and is being addressed in the Board's project on revenue recognition.

Issue

5. The issues are:

Issue 1— The appropriate method of amortization of an asset arising from an executory contract

Issue 2— The appropriate method of derecognition for a balance sheet credit arising from an executory contract.

Current EITF Discussion

6. At the November 12–13, 2003 EITF meeting, the FASB staff presented a proposed framework to address the subsequent accounting for assets and liabilities (or balance sheet credits) arising from executory contracts that are recognized on a company's balance sheet. The staff's proposed framework involved the following:

- Identifying the nature of the amount recognized relating to an executory contract as an asset, a liability, or a balance sheet credit that is, in concept, the reduction of an asset.[2]
- Considering the relevant authoritative literature governing the accounting for assets or liabilities of the nature identified for purposes of determining the appropriate method of derecognition
- Acknowledging that those balance sheet credits that are, in concept, the reduction of an asset, should be subject to accounting together with the related asset when recognized.

The Task Force discussed the staff's proposed framework but was not asked to reach a consensus. The Task Force asked the staff to consider the following additional issues relating to executory contracts:

a. Whether an executory contract—for example, an energy contract—acquired in a business combination that is valued based on the forward price curve that indicates periods during which the contract will produce positive cash flows and periods during which the contract will produce negative cash flows should be separated into an asset and a liability or, potentially, multiple assets and liabilities.

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[2] Paragraphs 251 and 252 of Concepts Statement 6 describe an estimated loss on a purchase contract as follows:

> Estimated loss on purchase commitments belongs in the second group of elements (paragraph 231) [that is, a liability, a reduction of an asset, a revenue, or a gain]. It is not a revenue or gain because it results from a loss. It is at best part of a liability and is not *by itself* an obligation to pay cash or otherwise sacrifice assets in the future. There is no asset from which it may be a deduction in present practice….
>
> A decrease in the price that leaves the committed buyer in the position of now being able to buy the assets cheaper were it not committed to buy them at the former, higher price does not by itself create an obligation that was not already present….The obligation to pay has been unaffected by the price decrease….However, the future economic benefit and value of the right to receive the assets has decreased because the market value of the assets to be received has declined, and the estimated loss on purchase commitment is *in concept a reduction of that asset*. [Emphasis added.]

b. If the contract should not be separated into multiple assets and liabilities (that is, the unit of account is the contract), when, if ever, negative amortization (an increase in the carrying value of the asset) or excess amortization (amortizing more than the original cost resulting in a balance sheet credit) would be appropriate.

7. The Task Force asked the FASB staff to develop views on these issues and to consider these issues in conjunction with EITF Issue No. 03-9, "Interaction of Paragraphs 11 and 12 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, Regarding Determination of the Useful Life and Amortization of an Intangible Asset."

Status

8. 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 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
00-18	Accounting Recognition for Certain Transactions involving Equity Instruments Granted to Other Than Employees	5/00	7/00, 7/01, 11/01, 1/02, 3/02	Not scheduled	Munro Durbin	Pending further progress in the Board's active project on share-based payment which is expected to include recognition and measurement for share-based transactions with non-employees.	Spring 2004
	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 sub-issues of Issue 00-18 (also related to Issues 96-18 and 00-8) are presently under consideration in the Board's share-based payment project.						
00-27	Application of EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," to Certain Convertible Instruments	5/00	11/00, 1/01	Not scheduled	Laurenzano Richards	Pending further progress on Phase II of the Board's *Liabilities and Equity* project.	2004

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
02-14	Whether the Equity Method of Accounting Applies When an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means	3/02	9/02, 11/02, 1/03, 3/03, 11/03	3/04	McBride Laurenzano	Formation of working group to (1) clarify the scope interaction of APB 18 and FAS 115 with respect to securities not explicitly subject to APB 18 and (2) develop a model for recording equity method earnings and losses.	12/03 or 1/04 working group meeting
02-D	The Effect of Dual-Indexation both to a Company's Own Stock and to Interest Rates and the Company's Credit Risk in Evaluating the Exception under Paragraph 11(a)(1) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*	3/02	N/A	Not scheduled	Laurenzano Sogoloff	Pending deliberations during Phase II of the Board's *Liabilities and Equity* project.	2004
03-1	The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments	1/03 (derived from 02/14)	3/03, 5/03, 7/03, 11/03	1/04	McBride Durbin	FASB staff to further refine the model proposed at the November meeting based on Task Force comments and propose a final model, including disclosures, at the January meeting.	January meeting materials
03-6	Participating Securities and the Two-Class Method under FASB Statement No. 128, *Earnings per Share*	3/03	5/03, 7/03, 11/03	1/04	Larson Sogoloff	FASB staff to propose final model at January meeting and discussion materials for reconsideration of Topic D-95 and the parallel consideration of the treatment of participating potential common stock in basic EPS.	January meeting materials

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
03-9	Interaction of Paragraphs 11 and 12 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, Regarding Determination of the Useful Life and Amortization of an Intangible Asset	5/03	7/03, 11/03	3/04	Durbin Pinson	Formation of a working group to consider issues in determining when a renewable intangible asset should be determined to have an indefinite life as well as circumstances when other-than-straight-line amortization may be appropriate and techniques for determining periodic amortization.	12/03 or 1/04 working group meeting
03-13	Applying the Conditions in Paragraph 42 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in Determining Whether to Report Discontinued Operations	5/03	11/03	1/04	Sogoloff Larson	Working Group to consider refinement of the model presented at the November meeting, including a better articulation of the principles to be considered in each of the Issues. Working Group to develop examples illustrating the application of the principles.	12/03 Working Group meeting.
03-15	Interpretation of an "Unconstrained Right to Pledge or Exchange" Transferred Assets in a Collateralized Bond Obligation	9/00 (AC) 11/02 (TF)	N/A	1/04	Laurenzano Lusniak	FASB staff to further develop initial Issue Summary based on comments received prior to November meeting and specifically consider implications of recent board decision with respect to QSPE's.	January meeting materials
03-16	Accounting for an Investments in Limited Liability Companies	4/01 9/03	11/03	1/04	Laurenzano Sogoloff	FASB staff to perform additional research on the legal structures of LLC's regarding the operation and presence of "specific ownership accounts."	January meeting materials

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	N/A	McBride O'Callaghan	Issues identified at the November meeting with respect to executory contracts that are partially recognized based on a differential value compared to a benchmark (for example, market price at date of acquisition) and the possibility of negative amortization to be explored as part of the Working Group on Issue 03-9.	Refer to Issue 03-9.
03-O	Whether Mineral Rights Are Tangible or Intangible Assets	11/03	N/A	TBD	TBD	TBD	TBD
03-P	Mineral Assets: Impairment and Business Combinations	11/03	N/A	TBD	TBD	TBD	TBD
03-Q	Allocation of Goodwill to Reporting Units for a Mining Enterprise	11/03	N/A	TBD	TBD	TBD	TBD
03-R	Accounting for Deferred Stripping Costs in the Mining Industry	11/03	N/A	TBD	TBD	TBD	TBD
03-S	Application of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, to Oil and Gas Companies	11/03	N/A	TBD	TBD	TBD	TBD

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
Issues Pending Further Consideration by the Agenda Committee							
	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.	