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April 3, 2003

TO: MEMBERS OF THE FASB EMERGING ISSUES TASK FORCE

Included are the final minutes of the March 20, 2003 meeting of the FASB Emerging Issues Task Force, (a marked version of the March 25, 2003 draft is also being provided to EITF members only), an inventory of open issues, and synopses of those issues for the next EITF meeting. After your review, please discard the confidential marked version of the minutes. An updated statistical summary of EITF Issues will be made available on the FASB Website.

Issue 02-9 Examples

The final minutes included herein do not include the examples relative to Issue 02-9. The FASB staff continues to work with Task Force members (or their designees) to refine certain aspects of those examples. Note that revisions being made to the examples do not impact the consensuses reached by the Task Force on this Issue. In that regard, an updated draft of those examples will be distributed tomorrow (Friday, April 4) for Task Force members to review. Comments on those examples should be communicated to the FASB staff (Vickie Lusniak, ext. 214) by no later than noon on Wednesday, April 9. Once finalized, the examples will be included as an addendum to the minutes of the March meeting.

Meeting Time and Location

The next EITF meeting will be held on **Thursday, May 15, 2003** at the FASB offices in Norwalk, Connecticut. At this time, the FASB staff believes that a one day meeting will be sufficient to cover related discussion materials. The meeting will start at **8:00 a.m.** and conclude no later than **4:00 p.m.**

EITF Agenda Committee Materials

Descriptions of proposed issues and any other items for EITF consideration should be submitted by no later than **Friday, April 11, 2003**, so that they may be considered by the EITF Agenda Committee and then distributed to Task Force members sufficiently in advance of the meeting.

Minutes

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

Draft minutes available	**May 20, 2003**
Final minutes available	**May 29, 2003**

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

Sincerely,

James N. Parrott
Practice Fellow

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MINUTES OF THE MARCH 20, 2003 OPEN MEETING OF THE FASB EMERGING ISSUES TASK FORCE

Location: FASB Offices
401 Merritt 7
Norwalk, Connecticut

Thursday, March 20, 2003

Starting Time:	8:00 a.m.
Concluding Time:	3:40 p.m.

Task Force Members Present:
Lawrence W. Smith (Chairman)
Frank H. Brod
Jack T. Ciesielski
Jackson M. Day (SEC Observer)
Leland E. Graul
Joseph F. Graziano
John M. Guinan
Stuart H. Harden
David L. Holman
James A. Johnson
David B. Kaplan
Louis W. Matusiak, Jr.
David H. Sidwell
Richard H. Stock
Mark V. Sever (AcSEC Observer)

Task Force Members Absent:
None

Others at Meeting Table:

G. Michael Crooch, FASB Board Member
John M. Foster, FASB Board Member
Robert H. Herz, FASB Board Member
Gary S. Schieneman, FASB Board Member
Katherine A. Schipper, FASB Board Member
Edward W. Trott, FASB Board Member
Mitchell A. Danaher, Incoming Task Force Member
Gregory A. Faucette, SEC Professional Accounting Fellow
Shelly C. Luisi, SEC Associate Chief Accountant
James N. Parrott, FASB Practice Fellow
Patrick G. Durbin, FASB Practice Fellow
* Jules M. Cassel, FASB Senior Technical Advisor
* Halsey G. Bullen, FASB Senior Project Manager
* Victoria A. Lusniak, FASB Assistant Project Manager
* Samuel O. Lynn, FASB Practice Fellow
* Gregory S. Martin, FASB Practice Fellow
* Lisa M. Munro, FASB Practice Fellow
* Brooke E. Richards, FASB Project Research Associate
* Michael W. Tovey, FASB Practice Fellow
* Robert C. Wilkins, FASB Senior Project Manager

* For certain issues only.

ADMINISTRATIVE MATTERS

- The Task Force Chairman announced that, effective with the May 15, 2003 EITF meeting, Mitchell A. Danaher of General Electric Company will replace David H. Sidwell from J.P. Morgan Chase as a member of the Task Force. The Task Force Chairman thanked Mr. Sidwell for many years of dedicated service to the EITF.

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

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

a. Determining Participating Securities and Allocation of Undistributed Earnings to Participating Securities under FASB Statement No. 128, *Earnings per Share*. The Agenda Committee decided to add this issue to the EITF agenda but agreed that the issue's scope should be refined to address certain definitional aspects with respect to "securities" and "participating securities" in the context of Statement 128.

b. Income Statement Characterization by a Lessor for Certain Executory Costs Paid Directly by the Lessee. The Agenda Committee decided not to add this issue to the EITF agenda. The Agenda Committee instead recommended that the FASB staff issue an FASB Staff Position addressing the appropriate income statement characterization of certain executory costs including, for example, property taxes, insurance, and maintenance.

c. Accounting for "Cash Balance" Pension Plans. The Agenda Committee decided to add this Issue to the EITF agenda for discussion at the March 20, 2003 EITF meeting. Refer to discussion of EITF Issue No. 03-4, "Accounting for 'Cash Balance' Pension Plans," elsewhere in these minutes.

d. Whether a Derivative Instrument Held for Trading Purposes May Be Designated as a Hedging Instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The Agenda Committee decided not to add this issue to the EITF agenda and indicated that the guidance 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," for determining if a derivative instrument is held for "trading purposes," was not intended to limit the ability to designate a derivative as a hedging instrument under Statement 133. The Agenda Committee directed the FASB staff to provide clarification in that regard through appropriate revisions to Issue 02-3 in *EITF Abstracts*. Refer to the proposed revisions to the minutes of Issue 02-3 elsewhere in these minutes.

e. The Application of the Exception under Paragraph 11(a)(1) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to Convertible Debt Involving Elements of Foreign Currency. The Agenda Committee agreed not to add this issue to the EITF agenda at this time. However, the Agenda Committee recommended that the FASB staff provide guidance on certain aspects of this issue through an FASB Staff Position.

f. Accounting Treatment of Emission Allowances Administered under the U.K. Emissions Trading Scheme. The Agenda Committee agreed to add this issue to the EITF agenda and recommended that the FASB staff consider whether the scope should be broadened to be relevant to other types of plans in other countries.

g. Issue No. 03-D, "Determining When an Investor is 'Otherwise Committed' to Provide Further Financial Support to an Equity Method Investee under APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*." The Agenda Committee recommended the removal of Issue 03-D from the EITF agenda. The Task Force agreed with that recommendation and observed that that issue involves a fundamental question as to the definition of a liability and/or the definition of a constructive obligation and is therefore too broad an issue to be addressed by the Task Force.

- The Task Force discussed, but was unable to finalize, certain potential revisions to the scope language of paragraph 4(a) of EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." The purpose of such revisions would be to clarify how to separate deliverables that are within the scope of higher-level literature from deliverables that are not. The Task Force Chairman identified certain Task Force members to help clarify the scope language in that regard with the intent of finalizing such language at the May 15, 2003 EITF meeting.

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

a. EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease" (2 comment letters)[1]

b. EITF Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor" (2 comment letters).[1]

- 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," appeared on the agenda for the March 20, 2003 EITF meeting but was not discussed. The Issue will be discussed at a future meeting.

[1] Discussion of comment letters occurred during the discussion of the related Issue.

REVISIONS TO *EITF ABSTRACTS*

Issue No. 02-3

Title: Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities

Prior to the rescission of EITF Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities," and *EITF Abstracts*, Topic No. D-105, "Accounting in Consolidation for Energy Trading Contracts between Affiliated Entities When the Activities of One but Not Both Affiliates Are within the Scope of Issue No. 98-10," an energy trading contract could be designated as a hedge. At its October 25, 2002 EITF meeting, the Task Force reached a consensus under Issue 02-3 to rescind Issue 98-10 (and the related interpretive guidance of EITF Issue No. 00-17, "Measuring the Fair Value of Energy-Related Contracts in Applying Issue No. 98-10," and Topic D-105) and preclude mark-to-market accounting for energy trading contracts that are not derivatives pursuant to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The Task Force also reached a consensus that gains and losses (realized and unrealized) on all derivative instruments within the scope of Statement 133 should be shown net in the income statement whether or not settled physically, if the derivative instruments are held for *trading purposes.* Footnote 2 of Issue 02-3 clarifies the meaning of *trading purposes* as follows:

> The determination of what constitutes "trading purposes" is based on the intent of the issuer or holder and shall be consistent with paragraph 12(a) of Statement 115 which characterizes trading as "active and frequent buying and selling…with the objective of generating profits on short-term differences in price." On an ongoing basis, reclassifications into and out of trading should be rare.

As a result of the additional guidance in Issue 02-3 on the definition of "trading purposes," questions have arisen as to whether that definition contradicts the hedge criteria in Statement 133 such that a derivative instrument held for trading purposes is not permitted to be designated as a "hedge."

The EITF Agenda Committee considered that issue at its February 25, 2003 meeting, and indicated that, in its view, the guidance in Issue 02-3 for determining if a derivative instrument is held for "trading purposes" was not intended to limit the ability to designate a derivative as a hedging instrument under Statement 133. That is, in its view, that guidance was provided only to indicate that gains and losses on all derivative instruments held for trading should be shown net when recognized in the income statement. The Task Force agreed with the Agenda Committee conclusion and agreed to make the following revisions to paragraph 16 of Issue 02-3 (additions are underscored):

> The Task Force Chairman noted that the consensus to rescind Issue 98-10 effectively supersedes the Task Force consensuses reached at the June 19–20, 2002 meeting on Issues 1 and 3. The Task Force discussed the income statement presentation of gains and losses on derivative instruments subject to Statement

133 when the gains or losses are realized by physically settling the derivative instrument. The Task Force reached a consensus that gains and losses (realized and unrealized) on *all* derivative instruments within the scope of Statement 133 should be shown net <u>when recognized</u> in the income statement, whether or not settled physically, if the derivative instruments are held for *trading purposes*. <u>A derivative held for trading purposes may be designated as a hedging instrument, prospectively, if all of the applicable criteria in Statement 133 have been met.</u> The Task Force also generally agreed that additional guidance from the Board is needed with respect to measuring fair value in the absence of quoted market prices or current market transactions with similar terms and counterparties. [Footnotes omitted.]

REVISIONS TO *EITF ABSTRACTS*

Issue No. 02-16

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

At the March 20, 2003 EITF meeting, the Task Force reconsidered the transition for the consensus in Issue 1 of Issue 02-16. The Task Force clarified that under the transition finalized at the January 23, 2003 EITF meeting, an entity would not be precluded from recasting prior-period financial statements provided it does not result in a change to previously reported net income. Further, the Task Force also concluded that entities that have not issued financial statements should be permitted to report the change in accounting as a cumulative-effect adjustment in accordance with APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, when the effect of applying the consensus on prior-period financial statements results in a change to previously reported net income. The SEC Observer reminded registrants to be cognizant of the MD&A disclosure requirements regarding the comparability of financial statement information. Accordingly, the Task Force agreed that the following revisions to the transition provisions of Issue 02-16 should be made in *EITF Abstracts* (additions are underscored and deletions are struck through):

Transition

Issue 1

13. The consensus on Issue 1 should be applied to new arrangements, including modifications of existing arrangements, entered into after December 31, 2002. If determinable, pro forma disclosure of the impact of the consensus on prior periods presented is encouraged. Early application of the consensus is permitted as of the beginning of periods for which financial statements have not been issued. Recasting of prior-period financial statements for comparative purposes is permitted provided that previously reported net income would not change as a result of applying the consensus.

14. An entity that has not issued financial statements also is permitted to report the change in accounting as a cumulative-effect adjustment in accordance with Opinion 20 and Statement 3 when the effect of applying the consensus on prior-period financial statements results in a change to previously reported net income. For example, an entity with a calendar year-end that has not issued financial statements for the year ended December 31, 2002, may adopt the consensus as a cumulative-effect adjustment as of either January 1, 2002, or January 1, 2003. However, an entity with a January 31 fiscal year-end that has not issued financial statements for the fiscal year ended January 31, 2003, could only adopt the

consensus as a cumulative-effect adjustment as of February 1, 2002. An entity should disclose the selected method of adopting the consensus on Issue 1.

15. The SEC Observer reminded registrants to consider the MD&A disclosure requirements regarding the comparability of financial statement information.

Issue 2

16~~4~~. The consensus on Issue 2 is effective for arrangements entered into after November 21, 2002.

DISCUSSION OF AGENDA TECHNICAL ISSUES

Issue No. 01-8

Title: Determining Whether an Arrangement Contains a Lease

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

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

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

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

FASB Statement No. 98, *Accounting for Leases*

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

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

FASB Statement No. 141, *Business Combinations*

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

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

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

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

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

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

International Accounting Standards 17, *Leases*

International Financial Reporting Interpretations Committee Draft Interpretation, "Determining Whether a Contract is a Lease"

Introduction

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

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

Issue

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

Prior EITF Discussion

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

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

[2] Refer to footnote 1.

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

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

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

   (1) Operate the property, plant, or equipment or direct others to operate the property, plant, or equipment (for example, the ability to fire and replace the asset's operator while obtaining the output of the asset or the approval of significant operating policies and procedures with respect to operating the asset), or

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

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

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

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

> The evaluation of whether an arrangement is a lease within the scope of Statement 13 should be based on the substance of the arrangement. Paragraph 1 of Statement 13 defines a lease as:
>
> > . . . an agreement conveying the *right to use* property, plant, or equipment (land and/or depreciable assets) usually *for a stated period of*

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

Property, plant, or equipment

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

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

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

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

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

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

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

Right to use property, plant, or equipment

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

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

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

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

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

output by the owner/seller to others, such that the purchaser has the right to take substantially all of the output expected to be produced by the property, plant, or equipment for a period of time or stated output.

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

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

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

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

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

Stated period of time

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

8. The Task Force requested that the Working Group provide the basis for its recommendations for inclusion in the abstract of this Issue. Additionally, the Task Force asked the Working Group to consider whether the fact that any party, other than the purchaser of

[8] In other words, the owner/seller is obligated to pay market-based liquidating damages over the term of the arrangement to compensate the purchaser for actual losses incurred as a result of the buyer's having to locate an alternative supply of the item required to be delivered from the specified property, plant, or equipment.

[9] For example, a lease of school buses could expire "at the end of the 2004–2005 school year." The fact that the school district had not yet set the calendar for the last day of school in 2005 should not lead to a conclusion that the contract is a service arrangement.

output, controls the use of the property, plant, or equipment should be determinative that the arrangement is not a lease within the scope of Statement 13.

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

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

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

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

> The evaluation of whether an arrangement ~~is~~<u>contains</u> a lease within the scope of Statement 13 should be based on the substance of the arrangement. Paragraph 1 of Statement 13 defines a lease as:
>
> > . . . an agreement conveying the *right to use* property, plant, or equipment (land and/or depreciable assets) usually *for a stated period of time*. It includes agreements that, although not nominally identified as leases, meet the above definition, such as a "heat supply contract" for nuclear fuel.[1] This definition does not include

[10] The *specified property, plant, or equipment* may be the undivided interest in property, plant or equipment.

> agreements that are contracts for services that do not transfer the right to use property, plant, or equipment from one contracting party to the other. On the other hand, agreements that do transfer the right to use property, plant, or equipment meet the definition of a lease for purposes of this Statement even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets. [Emphasis added.]
>
> ---
>
> [1]Heat supply (also called "burn up") contracts usually provide for payments by the user-lessee based upon nuclear fuel utilization in the period plus a charge for the unrecovered cost base. The residual value usually accrues to the lessee, and the lessor furnishes no service other than the financing.[3]

Property, plant, or equipment

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

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

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

Right to use property, plant, or equipment

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

a. Operate the property, plant, or equipment or direct others to operate the property, plant, or equipment in a manner it determines while obtaining or controlling the output or other utility of the property, plant, or equipment,~~.~~ ~~For example, the purchaser has the ability to do *any* of the following:~~
   ~~(1) To fire and replace the asset's operator while obtaining the output of the asset~~
   ~~(2) To approve significant operating policies and procedures with respect to operating the asset~~
   ~~(3) To specify significant operating policies and procedures in the arrangement with the owner/seller having no ability to change such policies and procedures.~~[7]

b. Control physical access to the underlying property, plant, or equipment or~~.~~ ~~For example, when *any* of the following conditions exist:~~
   ~~(1) The purchaser has use of property, plant, or equipment that is an integral part of the purchaser's facilities (and the purchaser has not provided the owner/seller with an easement granting free access to and from the property, plant, or equipment)~~
   ~~(2) The owner/seller is not able to use the property, plant, or equipment to provide goods or services to others (or for itself) without the purchaser's consent (even if the purchaser is not using the property, plant, or equipment)~~
   ~~(3) The property, plant, or equipment may not be used concurrently (at the discretion of the owner/seller or another third party) to provide significant services to entities unrelated to the purchaser.~~

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

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

~~the purchaser has the right to take substantially all of the output expected to be produced by the property, plant, or equipment for a period of time or stated output.~~

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

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

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

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

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

~~*Stated period of time*~~

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

Timing of assessment

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

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

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

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

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

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

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

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

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

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

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

Current EITF Discussion

13. At the March 20, 2003 EITF meeting, the FASB staff presented the Working Group's recommendations regarding transition, the timing of when an assessment is made, how the "substantially all" criterion is applied, and the interaction between Statement 13 and Statement 133 for arrangements that have attributes of both a lease and a derivative. The Task Force agreed to continue consideration of the general approach developed by the Working Group based on the previous tentative conclusion and certain subsequent Working Group recommendations. That approach is outlined in the draft abstract in Exhibit 01-8A. Several Task Force members expressed concern with the operationality of that approach and questioned whether the purchaser would have access to the information necessary to make the assessments required by that approach. Other Task Force members were still concerned with how the "substantially all" criterion (criterion (c) in the tentative conclusion) would be applied, while a few members suggested that that criterion should be eliminated altogether. The Task Force instructed the Working Group to:

a. Consider ways to improve the operationality of the tentative conclusion including whether the "substantially all" portion of the tentative conclusion should be based on estimated output or existing capacity
b. Consider whether the liquidated damages criterion (paragraph (c)(ii) in the tentative conclusion) should be retained
c. Recommend guidance regarding how the lease portion of an arrangement should be separated from the entire arrangement.

The Task Force Chairman requested that Task Force members provide the FASB staff with any other suggestions or comments for Working Group consideration in order to further refine and clarify the approach outlined in the tentative conclusion.

Status

14. Further discussion is expected at a future meeting.

Exhibit 01-8A

DRAFT FOR DISCUSSION PURPOSES

Draft Abstract for Issue No. 01-8

Title: Determining Whether an Arrangement Contains a Lease

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

References:
FASB Statement No. 13, *Accounting for Leases*
FASB Statement No. 23, *Inception of the Lease*
FASB Statement No. 66, *Accounting for Sales of Real Estate*
FASB Statement No. 98, *Accounting for Leases*
FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 141, *Business Combinations*
FASB Interpretation No. 21, *Accounting for Leases in a Business Combination*
FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*
FASB Concepts Statement No. 6, *Elements of Financial Statements*
FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*
AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*
SEC Staff Accounting Bulletin No. 101, "*Revenue Recognition in Financial Statements*"
International Accounting Standard 17, *Leases*
International Financial Reporting Interpretations Committee Draft Interpretation, "Determining Whether a Contract Is a Lease"

ISSUE

1. Prior to its rescission, Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities,"[1] required that when the trading criteria in the consensus were met, energy contracts (including energy-related contracts such as capacity

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

contracts, requirements contracts, and transportation contracts) were to be accounted for at fair value. Paragraph 5 of that Issue stated, however, that "in certain circumstances, transportation and other energy-related contracts may represent lease transactions that should be accounted for in accordance with Statement 13 and, therefore, are not within the scope of this Issue," and went on to state that "the determination of whether a transportation contract or some other type of energy-related contract is a lease is a judgmental decision based on the substance of each contract."

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

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

4. In applying this Issue, separate contracts with the same entity or related parties that are entered into at or near the same time are presumed to have been negotiated as a package and should, therefore, be evaluated as a single arrangement in considering whether there are one or more units of accounting. That presumption may be overcome if there is sufficient evidence to the contrary.

5. Leases that are within the scope of Statement 13 are not derivative instruments subject to Statement 133, although a derivative embedded in a lease may be subject to the requirements of Statement 133.

6. This Issue does not address whether an undivided interest or a pro rata portion of property, plant, or equipment could be the subject of a lease. That is, the issue of how to determine when a component part of property, plant, or equipment is itself property, plant, or equipment for purposes of applying Statement 13 is not the subject of this Issue. Nevertheless, arrangements that identify a physically distinguishable portion of property, plant, or equipment are within the scope of this Issue.

EITF DISCUSSION

7. The guidance in paragraph 8 should be used to determine whether an arrangement contains a lease that is within the scope of Statement 13. Examples illustrating the application of the guidance in this Issue are included in Appendix 01-8A. Appendix 01-8B summarizes the considerations deemed significant in developing the following guidance. Paragraph 1 of Statement 13 defines a lease as:

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[2] Refer to footnote 1.

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

Application Guidance

8. The evaluation of whether an arrangement contains a lease within the scope of Statement 13 should be based on the substance of the arrangement using the following guidance:

Property, plant, or equipment

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

Although specific property, plant, or equipment may be explicitly identified in an arrangement, it is not the subject of a lease if fulfillment of the arrangement is not dependent on the use of the specified property, plant, or equipment. For example, if the owner/seller is obligated to deliver a specified quantity of goods or services and has the right and ability to provide those goods or services using other property, plant, or

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

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

equipment not specified in the arrangement,[5] then fulfillment of the arrangement is not dependent on the specified property, plant, or equipment and the arrangement does not contain a lease. A warranty obligation[6] that permits or requires the substitution of other property, plant, or equipment does not preclude lease treatment. In addition, a contractual provision permitting or requiring (contingent or otherwise) the owner/seller to substitute other property, plant, or equipment for any reason on or after a specified date does not preclude lease treatment prior to the date of substitution.

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

Right to use property, plant, or equipment

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

a. Operate the property, plant, or equipment or direct others to operate the property, plant, or equipment in a manner it determines while obtaining or controlling more than a minor amount of the output or other utility of the property, plant, or equipment.[7]

b. Control physical access to the underlying property, plant, or equipment while obtaining or controlling more than a minor amount of the output or other utility of the property, plant, or equipment.

c. Take substantially all of the output or other utility reasonably expected to be produced or generated by the property, plant, or equipment for the term of the arrangement,[8] unless both of the following conditions are met:

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

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

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

[8] Assessed at the inception of the arrangement.

i. The price that the purchaser will pay for the output is either fixed per unit of output or indexed to market prices of the output.

ii. The arrangement requires the owner/seller to pay market-based liquidating damages to the purchaser if it fails to deliver,[9] and the owner/seller is a substantive entity with the financial ability to fulfill its obligations under the arrangement.

9. The assessment of whether an arrangement contains a lease should be made at inception of the arrangement based on all of the facts and circumstances. A reassessment of whether the arrangement contains a lease after the inception of the arrangement should be made only if (a) there is a change in the contractual terms, (b) a renewal option is exercised or an extension is agreed to by the parties to the arrangement, (c) there is a change in the determination as to whether fulfillment is dependent on specified property, plant, or equipment, (d) there is a substantial physical change to the specified property, plant, or equipment, or (e) there is a deconsolidation of entities under common control. Changes in estimate (for example, the estimated amount of output to be delivered to the purchaser or other potential purchasers) would not trigger a reassessment. The following more fully describes the above conclusions.

Change in contractual terms. The arrangement should be reassessed under paragraph 8 in this Issue if the contractual arrangement between the parties involved changes, unless the change only renews or extends the arrangement. For example, if the parties agree to add or delete a market-based liquidating damages provision to a contract, that modification would require a reassessment as of the modification date to determine if the arrangement contains a lease as of that date.

Renewal or extension. A renewal or extension of the arrangement that does not include modification of any of the terms in the original arrangement prior to the end of the term of the original arrangement should be evaluated under paragraph 8 in this Issue only with respect to the renewal or extension period. The accounting for the remaining term of the original arrangement should continue without modification. The exercise of a renewal option that was contemplated in the original accounting for the arrangement would not be considered a renewal for the purpose of reevaluating the arrangement. For example, a lease with a base term of 10 years and a purchaser renewal option for a second 10-year period would have been classified as having a 20-year term if the renewal option was determined to be reasonably assured of being exercised. Accordingly, the exercise of the renewal option would not trigger a reassessment under paragraph 8 in this Issue.

Dependency upon specific property, plant, or equipment. A change in the determination as to whether fulfillment is dependent on specified property, plant, or equipment requires a

[9] Market-based liquidating damages require the seller (if the defaulting party) to compensate the purchaser (the injured party) for any excess of the market price over the contracted price of the output for the stipulated volume of output so that the purchaser has the ability to obtain the contracted volume of output from a readily accessible alternative source without incurring additional costs. If the contractual price per unit is indexed to market prices, there may be no requirement for damages in certain circumstances, except for refunding amounts previously paid by the purchaser for quantities that were not delivered.

reassessment of the arrangement under paragraph 8 of this Issue to determine whether the arrangement contains a lease on a go-forward basis. For example, if an arrangement was initially determined to include a lease because, in part, fulfillment of the arrangement was initially dependent upon specific property, plant, or equipment and an event or events occurred subsequent to the inception of the arrangement such that fulfillment was no longer dependent upon the specific property, plant, or equipment (for example, an active market for the product develops subsequent to inception of the arrangement), the arrangement would be reassessed to determine if the arrangement contains a lease as of the date that the arrangement is no longer dependent upon specific property, plant, or equipment.

Physical change to specific property, plant, or equipment. A substantial physical change to the specified property, plant, or equipment requires a reassessment of the arrangement under paragraph 8 in this Issue to determine whether the arrangement contains a lease on a go-forward basis. For purposes of determining if a physical change to the specified property, plant, or equipment gives rise to a reassessment, increases or decreases in productive capacity that result from adding or subtracting a physically distinct unit of property, plant, or equipment should be ignored. For example, a machine generates 100 units of productive capacity at inception. If the seller increases capacity to 200 units by installing a second machine that is physically distinct from, and is capable of being operated independently of, the original machine, the increase in capacity would not give rise to a reassessment. Conversely, if the original machine is replaced by a new machine that is capable of generating 200 units of productive capacity, reassessment would be appropriate. Although a substantial physical change to the specified property, plant, or equipment requires a reassessment of the arrangement, the assessment of whether the purchaser has the right or ability to take substantially all of the output from the property, plant, or equipment (paragraph (c) of paragraph 8 of this Issue) is based on the output reasonably expected to be produced or generated during the remaining term of the arrangement.

Deconsolidation of entities under common control. If the contractual arrangements are between entities under common control, the arrangement should be assessed under paragraph 8 in this Issue upon deconsolidation. The arrangement is viewed as a new arrangement when sufficient third-party interests become involved.

10. When an arrangement (or a portion of an arrangement) ceases to be a lease due to a modification to the arrangement or other change discussed above, the net of the capitalized lease asset and lease obligation for the lessee (if applicable) becomes the new carrying value of the arrangement. However, any net asset position should be recognized at the lower of historical cost or fair value with any excess recognized in earnings as of the date of modification or other change. The lessor in a sales-type or direct financing lease should record the property, plant, or equipment, as of the date of modification or other change, at the lower of the original cost of the property, plant, or equipment, the present fair value of the property, plant, or equipment, or the present carrying amount of the lease receivable.

11. When an arrangement (or a portion of an arrangement) becomes a lease due to a modification to the arrangement or other change discussed above, the carrying value of the

arrangement (if applicable) would be included in the basis of the lease asset or lease obligation. For example, suppose the purchaser is currently recognizing an arrangement at fair value and a modification to the arrangement results in the arrangement becoming an operating lease. The present carrying value of the arrangement is recognized as prepaid rent (if an asset) or as a lease incentive received (if a liability). If a capital lease, the present carrying value of the arrangement would become part of the asset balance as if the arrangement were settled upon acquisition of the property, plant, or equipment.

Transition

12. Transition is to be specified by the Task Force.

STATUS

13. No further EITF discussion is planned.

Appendix 01-8A

EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUS ON ISSUE 01-8

Example 1

A production company (the purchaser) enters into an arrangement with a third party to supply a minimum quantity of a specialty gas needed in its production process for a specified period of time. The supplier designs and constructs a facility adjacent to the purchaser's plant to produce the needed gas and maintains ownership and control over all significant aspects of operating the facility. The agreement provides for the following:

- The facility is explicitly identified in the arrangement, and the supplier has the contractual right to supply gas from other sources. However, supplying gas from other sources is not economically feasible or practicable.
- The supplier has the right to provide gas to other customers and to remove and replace the facility's equipment and modify or expand the facility to enable the supplier to do so. However, at inception of the arrangement, the supplier has no plans to modify or expand the facility. The facility is designed to meet only the purchaser's needs.
- The supplier is responsible for repairs, maintenance, and capital expenditures.
- The supplier must stand ready to deliver a minimum quantity of gas each month.
- On a monthly basis, the purchaser will pay a fixed capacity charge and a variable charge based on actual production taken. The purchaser must pay the fixed capacity charge irrespective of whether it takes any of the facility's production. The variable charge includes the facility's actual energy costs, which comprise approximately 90 percent of the facility's total variable costs. The supplier is subject to increased costs resulting from the facility's inefficient operations.
- In the event that the facility does not produce the stated minimum quantity, the supplier must return all or a portion of the fixed capacity charge. The arrangement does not provide for market-based liquidating damages.

Evaluation:

The arrangement contains a lease within the scope of Statement 13. Property, plant, or equipment (the facility) is explicitly identified in the arrangement and fulfillment of the arrangement is dependent on the facility. While the supplier has the right to supply gas from other sources, its ability to do so is nonsubstantive. The purchaser has obtained the *right to use* the facility because the purchaser has the right to take substantially all of the facility's output and the price the purchaser pays is neither fixed per unit of output nor indexed to market prices of the output. The arrangement includes a lease term, as defined by Statement 13.

Example 2

A manufacturing company (the purchaser) enters into an arrangement with a third party to supply a specific component part of its manufactured product for a specified period of time. The supplier designs and constructs a plant adjacent to the purchaser's manufacturing facility to produce the component part. The designed capacity of the plant exceeds the purchaser's current needs, and the supplier maintains ownership and control over all significant aspects of operating the plant. The arrangement provides for the following:

- The supplier's plant is explicitly identified in the arrangement, but the supplier has the right to fulfill the arrangement by shipping the component parts from another plant owned by the supplier. However, to do so for any extended period of time would be uneconomical.
- The supplier must coordinate its scheduled plant downtime with the purchaser's scheduled plant downtime, although the supplier has the ability to manufacture and store a sufficient quantity of the component part to supply the purchaser in the event that the supplier's plant is down or producing parts for other customers.
- The supplier is responsible for repairs, maintenance, and capital expenditures of the plant.
- The supplier must stand ready to deliver a minimum quantity. The purchaser is required to pay a fixed price per unit, renegotiated annually, for the actual quantity taken. Even if the purchaser's needs are such that they do not need the stated minimum quantity, they still only pay for the actual quantity taken.
- The supplier has the right to sell the component parts to other customers and has a history of doing so (sells in the replacement parts market for the specific manufactured product) such that it is expected that the purchaser will not take substantially all of the component parts produced at the supplier's plant that is adjacent to the purchaser's manufacturing facility.

Evaluation:

The arrangement is *not* within the scope of this Issue. Property, plant, or equipment (the plant) is explicitly identified in the arrangement, and fulfillment of the arrangement is dependent on the facility. While the supplier has the right to supply component parts from other sources, the supplier would not have the ability to do so because it would be uneconomical. However, the purchaser has not obtained the *right to use* the plant because the purchaser does not have the ability or right to (a) operate or direct others to operate the plant, (b) control physical access to the plant, or (c) take substantially all of the plant's output.

Appendix 01-8B

BACKGROUND INFORMATION AND BASIS FOR CONSENSUS

Introduction

B1. This exhibit summarizes considerations that Task Force members deemed significant in reaching the conclusions in this consensus. It includes reasons for accepting certain approaches and rejecting others. Individual Task Force members gave greater weight to some factors than to others.

Scope of Issue

B2. The Task Force originally raised the Issue during its deliberations on the accounting for energy trading activities. However, the issue of whether an arrangement contains a lease is not unique to energy-related contracts. The same issue may arise in outsourcing arrangements, such as the outsourcing of the data processing functions of an enterprise (it may be a significant element, particularly in those arrangements that require a substantial investment in computer hardware and terminals devoted solely to the use of a single customer), in the telecommunications industry where providers of network capacity (primarily in the form of conduit, fiber optic cables, and related equipment) often grant rights to capacity on the basis of an indefeasible right of use, and in some take-or-pay contracts. The Task Force agreed that the scope of this Issue should be expanded to address the broader question of how to determine whether any arrangement contains a lease within the scope of Statement 13.

Approach to Address Issue

B3. Based on the definition of a lease in paragraph 1 of Statement 13, determining whether an arrangement contains a lease requires the evaluation of whether the arrangement conveys the *right to use* the underlying property, plant, or equipment to a nonowner. The Task Force discussed whether that evaluation should be based on the explicit terms in the arrangement or whether it should be based on the substance of the arrangement—that is, whether the evaluation should depend on whether the arrangement explicitly provides for the use of specific property, plant, or equipment or whether the substance of each arrangement should be evaluated in order to determine whether the right to use property, plant, or equipment is conveyed (perhaps implicitly).

B4. The Task Force agreed that the evaluation of whether an arrangement conveys the right to use the underlying property, plant, or equipment should be based on the substance of the arrangement. Prior to its rescission, paragraph 5 of Issue 98-10 stated that "the determination of whether a transportation contract or some other type of energy-related contract is a lease is a judgmental decision based on the *substance* of each contract" (emphasis added). The fact that a contract is labeled a "transportation contract" is not determinative that the contract is not a lease, and the fact that a contract is labeled a "lease" is not determinative that the contract is a lease. Additionally, the fact that the definition of a lease in paragraph 1 of Statement 13 includes agreements that may not be nominally identified as leases implies that the evaluation should be based on the substance of the arrangement. The SEC, in addressing reporting by hotel management companies, has also indicated that "determining whether a contract is a service agreement or a lease is dependent on the facts and circumstances, and requires a rigorous analysis of the rights, obligations, risks and rewards of the management company and the property owner" (Division of Corporate Finance's *Current Accounting and Disclosure Issues*, March 2001).

Multiple Element Arrangements That Contain a Lease

B5. The Task Force agreed that Statement 13 provides for separate recognition of a lease that is embedded in a multiple-element arrangement, based on the language in paragraph 1 and the definition of minimum lease payments in paragraph 5(j) (which excludes any portion of the payment attributable to executory costs, including amounts paid for maintenance) used for purposes of determining lease classification. To clarify that this Issue addresses multiple-element arrangements that include a lease (and not just whether an *entire* arrangement is a lease), the title of the Issue was changed to more appropriately reflect that point (Determining Whether an Arrangement Contains a Lease) and also to converge with the IFRIC proposed Interpretation to IAS 17, which also will apply to multiple-element arrangements that contain a lease.

B6. Some Task Force members expressed concern that the guidance in Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables," on separation of deliverables differs from that of Statement 13 on separation of a lease from other elements in an arrangement. However, Statement 13 requires separation of the lease element in a multiple-element arrangement in all circumstances. In addition, the guidance in Statement 13 on how to measure and allocate consideration associated with the lease element in a multiple-element transaction differs from that required by Issue 00-21 (principally due to the guidance in Issue 00-21 on consideration that is contingent on future performance), so Issue 00-21 should not be applied in determining whether to separate the lease from the other elements of a multiple-element arrangement (although Issue 00-21 may apply to any other portions of the arrangement).

Property, Plant, or Equipment

B7. The Task Force discussed the scope of *property, plant, or equipment* as that term is used in Statement 13. In practice, there appears to be differing views as to what constitutes property, plant, or equipment. Paragraph 1 of Statement 13 parenthetically defines property, plant, or equipment as "land and/or depreciable assets." However, some constituents have argued that certain arrangements involving nondepreciable assets are within the scope of Statement 13. For example, "parts leasing" arrangements are being marketed to the aviation and computer parts industries. Under those arrangements, the parts manufacturer or supplier and the parts user agree on a list of parts that make up the "leased asset." The user makes a periodic (or usage) payment to the supplier, and ownership of the parts (as evidenced by UCC filings) resides with the supplier. At the end of the arrangement's term, the user has the ability to purchase the parts at the then fair value or may return any unused parts. Another example of an arrangement in which nondepreciable assets are the subject of a "lease" involves precious metals. A supplier "leases" a quantity of precious metals to a manufacturer. The manufacturer uses the precious metals in its manufacturing process and salvages the same metals from used product. At the end of the arrangement, the manufacturer returns the same quantity of precious metals (either from salvage or by purchasing from others) to the supplier.[10]

B8. The Task Force agreed that property, plant, or equipment, as used in Statement 13, must be land and/or depreciable assets. Therefore, inventory (including equipment parts inventory) and minerals, precious metals, or other natural resources cannot be the subject of a lease because those assets are not depreciable.[11]

B9. The Task Force discussed whether specific property, plant, or equipment needs to be identified (either explicitly or implicitly) in the arrangement in order for the arrangement to contain a lease. The Task Force agreed that the subject of the lease must be specified no later than the beginning of the *lease term*.[12] However, the identification of the property in the arrangement need not be explicit; it may be implicit. For example, in the case of a power purchase contract, if the seller of the power is a special purpose entity (SPE) that owns a single power plant (and that plant is not connected to the power grid), that power plant is implicitly specified in the contract because it is unlikely that the SPE could obtain replacement power to fulfill its obligations under the contract because an SPE generally has limited capital resources. Similarly, in the case of a throughput contract, the seller may have only a single pipeline, and the prospect of obtaining access to a second pipeline may not be economically feasible. In that case, the seller's pipeline is implicitly specified in the contract. If, on the other hand, no property, plant, or equipment is explicitly specified in the contract and it is economically feasible for the seller to perform its obligation independent of the operation of a particular asset, there would be no implicit specification of the property, plant, or equipment and such a contract would not contain a lease.

Lease Term

B10. The Task Force discussed whether a period of time needs to be stated for an arrangement to contain a lease. The Task Force agreed that although a lease normally provides for the use of property, plant, or equipment for a specified period of time, an arrangement providing for a specified measure of use (for example, a number of units produced) would be within the scope of Statement 13. The arrangement must include a "lease term" as defined in paragraph 5(f) of Statement 13 (amended by paragraph 22 of Statement 98). The "term of the lease" could be a period of time or measure of use. This does not preclude the measure of time from being specified as contingent on a future event. For example, a lease of school buses could expire "at the end of the 2004–2005 school year." The fact that the school district had not yet set the calendar for the last day of school in 2005 should not lead to a conclusion that the contract is a service arrangement.

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[10] This arrangement likely contains an embedded derivative that would need to be analyzed pursuant to Statement 133 (for example, a gold loan is a loan host contract with an embedded forward contract).

[11] Additionally, Statement 13 explicitly excludes "lease agreements concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and timber" and "licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights."

[12] As defined in paragraph 5(b) of Statement 13 (amended by paragraph 6 of Statement 23).

B11. The Task Force agreed that Statement 13, as amended, is sufficiently clear in defining the lease term so there is no need to provide additional guidance in this Issue.

Right to Use

B12. When specific property, plant, or equipment is explicitly identified and the benefits of the property, plant, or equipment are conveyed based on time, application of paragraph 1 of Statement 13 is fairly simple (the arrangement likely contains a lease). The difficulty in determining whether an arrangement contains a lease arises when the *right to use* the underlying property, plant, or equipment is conveyed in some other manner (for example, based on the output of the property, plant, or equipment). With that, the Task Force focused on how to determine whether an arrangement conveys the *right to use* the specified property, plant, or equipment when the purchaser receives some or all of the output from the property, plant, or equipment. The Task Force generally agreed that an arrangement conveys the *right to use* property, plant, or equipment if the arrangement conveys to the purchaser (lessee) the right to physically control the use of the underlying property, plant, or equipment, either through operations or access. Additionally, the Task Force generally agreed that if the purchaser has the right to substantially all of the output or other utility expected to be provided by the property, plant, or equipment and the pricing under the arrangement is substantially dependent upon the specific property, plant, or equipment, the arrangement conveys the *right to use* the property, plant, or equipment.

B13. Some Task Force members believe that the determination of whether the purchaser has obtained the *right to use* the property, plant, or equipment specified in the arrangement should include more of an assessment of the risks and rewards inherent in owning the property, plant, or equipment. For example, some members suggested that if the purchaser guarantees the future value of the asset or has a bargain purchase option on the asset, then the purchaser may have obtained the *right to use* the property, plant, or equipment. In reaching the consensus, the Task Force considered an approach that evaluated whether certain risks and rewards incident to ownership are conveyed in an arrangement, but ultimately eliminated that approach because risks and rewards of ownership are characteristics relevant to lease classification not to whether a lease exists.

B14. Several Task Force members questioned what is meant by "substantially all" (in paragraph (c) of paragraph 8); that is, what is meant by "expected to be produced or generated by the property, plant, or equipment" in determining what to include in the denominator. They questioned whether expectations are based on the property's then-existing productive capacity, potential productive capacity, or demand for the product (irrespective of capacity). For example, assume a power plant is capable of producing 100 MW and one customer has contracted to purchase 50 MW for a fixed term. The supplier does not reasonably expect to sell to any other customers during the term of the arrangement. In assessing whether the customer has the right or ability to take *substantially all of the output or other utility reasonably expected to be produced or generated* by the power plant, should the parties to the arrangement look to the existing capacity of the power plant (100 MW) or the expected production from the power plant over the term of the arrangement (50 MW)? The Task Force agreed that in assessing whether the purchaser has the right or ability to take substantially all of the output or other utility reasonably expected to be produced or generated by the property, plant, or equipment, the parties would *not* look to the existing or potential productive capacity of the property, plant, or equipment. Rather, the parties would estimate the amount of production or output that is *reasonably expected to be produced or generated* during the term of the arrangement, based on all of the relevant facts and circumstances then existing, including (but not limited to) potential customers and the arrangement's pricing.

B15. Some Task Force members questioned the intent of the market-based liquidating damages criterion (in paragraph 8(c)(ii)) when the purchaser has the ability or right to take substantially all of the output or other utility reasonably expected to be produced or generated by the specified property, plant, or equipment. The intent of that criterion, coupled with the criterion in paragraph 8(c)(i), is to ensure that the purchaser is economically indifferent as to the source of the output being acquired. That is, the purchaser should only be exposed to the risks and rewards of the output or product being purchased rather than the risks and rewards of the property, plant, or equipment. If stipulated damages are other than market-based (for example, a fixed penalty or return or reimbursement for business interruption costs), the purchaser would be exposed, to some extent, to the risks and rewards incident to owning the property, plant, or equipment.

B16. In order for damages to be "market-based," the purchaser must be able to obtain the contracted volume of output from a readily accessible alternative source without incurring additional costs. That is, there must be an active market for the subject output. Yet-to-be constructed property, plant, or equipment that is needed in order to provide the output, is not considered a readily available alternative source. The market-based liquidated damages criterion will generally only be met when the output to be delivered under the arrangement is a commodity traded in an active market.

B17. The effect of clarifying *right to use* in the manner provided for by the consensus may result in many take-or-pay arrangements being recognized as leases. That is because the purchaser makes payments for the time that the property, plant, or equipment is made available for use rather than on the basis of actual use or output (resulting in the arrangement's pricing being neither fixed per unit of output nor indexed to market prices). In many take-or-pay arrangements, the purchaser is contractually committed to pay the supplier irrespective of whether the purchaser actually uses the property, plant, or equipment or obtains the output from the property, plant, or equipment. In such arrangements, the purchaser is paying for the *right to use* the property, plant, or equipment.

Undivided Interests (or a Pro Rata Portion of Property, Plant, or Equipment)

B18. The Task Force is divided on the issue of whether a pro rata portion of the output of an asset (for example, a pro rata undivided interest) can be the subject of a lease. Some Task Force members note the guidance in SOP 78-9 on accounting for an investment in real estate in which the investor has a direct undivided ownership interest and the guidance relating to partial sales of real estate in Statement 66. They also note the longstanding practice in project finance of leasing undivided interests in power or extractive facilities.[13] Still other Task Force members argue that an undivided interest in property, plant, or equipment is different in character from a physical asset because the undivided interest represents an economic right with respect to the physical asset rather than the physical asset itself. They note that the Statement 13 definition of a lease is based on the right to use a physical asset (land and/or depreciable assets). They also look to Technical Bulletin 88-1, which indicates that the right to control the use of the leased asset is the equivalent of physical use, inferring that an undivided interest owner must be able to physically use the property, plant, or equipment.

B19. In the interests of making progress on this Issue and converging this Issue with the IFRIC draft Interpretation of IAS 17, the Task Force agreed to be silent on the issue of whether a pro rata undivided interest can be the subject of a lease. However, the Task Force agreed that a non–pro rata portion of property, plant, or equipment could be the subject of a lease. That is, when a portion of an asset is physically distinguishable from the larger asset, that portion could be the subject of a lease (for example, one or more floors of an office building).

Derivatives

B20. The Task Force discussed the scope of the Issue and the concern of some of its members that the scope may include contracts that may be derivatives pursuant to Statement 133. Certain IFRIC members had the same concern when debating their draft Interpretation of IAS 17. The IFRIC agreed to explicitly exclude arrangements that fall within the scope of IAS 39 (derivatives). Issue 01-12 addressed a similar scope overlap question. Issue 01-12 resolved the scope overlap between Statement 13 and Statement 133 with respect to residual value guarantees. In that issue, the Task Force reached a consensus that residual value guarantees that are subject to the requirements of the lease accounting literature (including Statement 13) are not subject to the requirements of Statement 133 due in part to the fact that Statement 133 did not amend Statement 13 (concluding that the Board did not intend to change the accounting for leases in relation to the issue). Consistent with the consensus in Issue 01-12, the Task Force believes the fact that the Board did not amend Statement 13 to exclude derivatives that are subject to Statement 133 from its scope suggests that the Board did not intend to change the scope of Statement 13. As such, this Issue explicitly states that leases within the scope of Statement 13 are not derivative instruments subject to Statement 133, although a derivative embedded in a lease is subject to Statement 133.

B21. Notwithstanding the discussion in paragraph B20, above, in most cases, a lease would never be a derivative and vice versa (that is, the two standards should not overlap). A derivative is a right to the changes in value of the asset related to the underlying, whereas a lease is a *right to use* the asset (property, plant, or equipment). Additionally, paragraph 10(e)(2) of Statement 133 excludes from its scope contracts that are not traded on an exchange if the underlying is the price or value of a nonfinancial asset that is not readily convertible to cash. However, some Task Force members questioned whether the guidance in this Issue contradicts the guidance in

[13] In practice, if a co-ownership/undivided interest has been or would be properly classified as a depreciable asset under GAAP (for example, if the underlying physical asset generates fungible units that each co-owner can take and dispose of independently of the other co-owners), then the interest may be the subject of a lease.

paragraph 59(c) of Statement 133 on that statement's assessment of take-or-pay contracts. Paragraph 59(c) states:

> *Take-or-pay contracts*. Under a take-or-pay contract, an entity agrees to pay a specified price for a specified quantity of a product whether or not it takes delivery. Whether a take-or-pay contract is subject to this Statement depends on its terms. For example, if the product to be delivered is not readily convertible to cash and there is no net settlement option, the contract fails to meet the criterion in paragraph 6(c) and is not subject to the requirements of this Statement. *However, a contract that meets all of the following conditions is subject to the requirements of this Statement: (1) the product to be delivered is readily convertible to cash, (2) the contract does not qualify for the normal purchases and normal sales exception in paragraph 10(b), and (3) little or no initial net investment in the contract is required.* [Emphasis added.]

B22. The fact that a contract is labeled "take-or-pay" is not determinative that the contract is not a lease. Whether a "take-or-pay" contract is subject to Statement 13, to Statement 133, or to neither depends on its terms. Statement 13 and the guidance in this Issue should be applied first to determine whether a take-or-pay contract is within the scope of Statement 13. Any portion of the arrangement that is not a lease may be subject to Statement 133 (or any other GAAP), and any lease portion of the arrangement may contain an embedded derivative that is subject to Statement 133. Nevertheless, a "take-or-pay" contract that meets all of the conditions in paragraph 59(c) of Statement 133 will, in most cases, not be a lease due to the requirement that the product to be delivered be readily convertible to cash. In order for an asset to be readily convertible to cash, it must have quoted market prices available in an active market.[14] Most arrangements that call for delivery of an asset that has quoted market prices available in an active market will generally not be dependent upon specific property, plant, or equipment to fulfill the arrangement. However, in the unlikely event that the arrangement is dependent upon specific property, plant, or equipment and the other criteria in this Issue are met, Statement 13 is applied to the lease portion of the arrangement.

Capital Leases

B23. Some Task Force members suggested that if an arrangement meets one of the four criteria in paragraph 7 of Statement 13 to be classified as a capital lease by the lessee, the arrangement should automatically be a lease within the scope of Statement 13 (that is, this Issue should affirmatively include those arrangements within its scope). However, the focus of the Issue is on identifying when an arrangement contains a lease. The fact that an arrangement conveys certain risks and rewards incident to ownership is not in and of itself determinative that the arrangement conveys the right to use the underlying property, plant, or equipment.[15] In reaching the consensus, the Task Force generally agreed that potential lease classification is not a basis for determining whether the arrangement contains a lease.

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[14] Footnote 5 to paragraph 9(c) of Statement 133.

[15] However, an arrangement that conveys the right to use property, plant, or equipment will typically also convey certain risks and rewards of ownership. Therefore, the transfer of risks and rewards of ownership may be indicative that the arrangement conveys the right to use property, plant, or equipment.

Issue No. 02-2

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

Dates Discussed: January 23–24, 2002; January 23, 2003; March 20, 2003

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

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

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

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

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

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

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

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

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

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

Introduction

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

Issue

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

Prior EITF Discussion

3. At the January 23–24, 2002 EITF meeting, the FASB staff reported on the initial meeting of the Working Group. The Working Group preliminarily agreed that two or more financial

instruments should be required to be combined for accounting purposes if *all* of the following four criteria are met:

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

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

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

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

6. At the January 23, 2003 EITF meeting, the FASB staff informed the Task Force of the Board's intent to issue FASB Statement, *Accounting for Certain Financial Instruments with Characteristics of Liabilities and Equity*, in the short term. The FASB staff stated that that Statement results from Phase One of the liabilities and equity project and, as currently drafted, requires liability classification for certain financial instruments that were previously classified as equity. Instruments within the scope of that Statement are classified as liabilities and measured accordingly and are specifically precluded from being combined with other freestanding

financial instruments. Consequently, financial instruments included in the scope of that Statement would no longer be subject to a combining model to be developed in this Issue. Additionally, the FASB staff stated that Phase Two of the liabilities and equity project is expected to start immediately following the issuance of the final Statement for Phase One and that a final Statement for Phase Two is projected to be issued by the end of 2003. The Task Force discussed whether it would be appropriate to continue its discussions of this Issue in light of the Board's concurrent activities in developing classification and separation guidance for instruments within the scope of the liabilities and equity project. As a result of those discussions, the Task Force directed the FASB staff (and the Working Group) to continue to work on this Issue only for financial instruments that are outside the scope of the liabilities and equity project. The scope of the Board's project, as communicated in the October 2000 Exposure Draft on liabilities and equity, includes financial instruments with characteristics of liabilities or equity or both.

Current EITF Discussion

7. At the March 20, 2003 EITF meeting, the FASB staff reported that, at its most recent meeting, the Working Group agreed that if the scope of this Issue was limited to financial instruments outside the scope of the liabilities and equity project (which would only address the combining of assets), that scope would be too narrow to be meaningful. As such, the Working Group recommended that the Task Force develop a comprehensive model for combining *all* types of transactions, including those that involve financial or nonfinancial instruments, similar to the IFRIC project on Linkage.[1]

8. In discussing the Working Group's recommendations, the Task Force agreed that limiting the scope of this Issue to the combining of assets would not result in additional guidance that would be meaningful. The Task Force also discussed whether it should develop combining guidance for all types of transactions as recommended by the Working Group. The Task Force concluded that it should not expand the scope of this Issue to address all types of transactions, but would consider developing guidance for specific arrangements, including nonfinancial transactions, for which guidance is necessary. While the Task Force decided to discontinue discussions of this Issue, it recommended that the Board undertake a project to develop comprehensive guidance for when arrangements should be combined for accounting purposes.

9. The SEC Observer encouraged the Board to examine the broader issue of when to combine transactions and noted that, in the interim, the SEC staff will continue to challenge the accounting for transactions for which it appears that multiple contracts have been used to circumvent generally accepted accounting principles.

Status

10. No further EITF discussion is planned.

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[1] Linkage is when the accounting treatment for two or more transactions or contracts differs depending on whether the contracts are accounted for separately or together [per IFRIC Agenda Paper 11, dated February 2003].

Issue No. 02-9

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

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

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

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. 114, *Accounting by Creditors for Impairment of a Loan*

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

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

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

FASB Statement No. 141, *Business Combinations*

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

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

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

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

APB Opinion No. 16, *Business Combinations*

APB Opinion No. 20, *Accounting Changes*

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

SEC Staff Accounting Bulletin No. 61, *Adjustments of Allowances for Business Combination Loan Losses—Purchase Method Accounting*

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

Introduction

1. A key concept in Statement 140 is that a transferred asset that has been accounted for as sold is accounted for as "re-purchased" if the basis for that sale accounting becomes invalid subsequent to the initial accounting for the transaction. That concept is articulated in paragraph 55 of Statement 140, which states:

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

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

2. A qualifying SPE may become nonqualifying or "tainted" for several reasons, including a decision by the outside beneficial interest holders to grant the SPE decision-making powers that are prohibited for qualifying SPEs. Under the requirements of paragraph 55, the disqualification of a formerly qualifying SPE will generally result in the "re-purchase" by the transferor of *all* assets sold to and still held by the SPE because the transferee (the SPE that is no longer qualifying) is constrained from pledging or exchanging the financial assets and this condition provides more than a trivial benefit to the transferor (refer to paragraph 9(b) of Statement 140). This Issue considers the application of the guidance in paragraph 55 prior to any consideration of whether the transferee (for example, an SPE) should be consolidated and, therefore, prior to considering any eliminating entries that may result from consolidation.

3. Under Statement 140, rights held by the transferor (typically in the form of purchased options or forward purchase contracts) only preclude sale accounting under paragraph 9(c)(2) if they provide the transferor with the *unilateral* right to cause the holder to return *specific* transferred assets. One class of contingent rights (including certain ROAPs[1]) does not preclude

[1] Although this Issue uses ROAPs as an example, the guidance is not limited to ROAPs. Contingent rights can arise in many other fact patterns. Refer to Question 49 of the Statement 140 Special Report for more information.

sale accounting because it does not include unilateral rights. The most common type of ROAP is a default ROAP, which gives the holder the right but not the obligation to purchase (call) a loan that is in default (the meaning of default typically is specifically defined in each transaction). Such rights are common in credit card securitizations and in securitizations sponsored by the Government National Mortgage Association (GNMA)[2] and other governmental or quasi-governmental agencies. Once the contingency is met (in this case, when a given loan goes into default), the call option on that asset (loan) is no longer contingent. At that point, the transfer fails the criterion in paragraph 9(c)(2) of Statement 140 because the transferor has the unilateral right to purchase a specific transferred asset. Under the requirements of paragraph 55 , when a contingency related to a transferor's contingent right has been met, the transferor generally must account for the "re-purchase" of *a specific subset* of the assets transferred to and held by the qualifying SPE. The transferor must do so *regardless of whether it intends to exercise its call option*.

Issues

4. The issues are:

Issue 1—How the transferor should account for retained beneficial interests when the underlying assets are re-recognized under the provisions of paragraph 55 because the transferor's contingent right (for example, a "ROAP" or other contingent call option on the transferred financial assets) becomes exercisable, including whether any gain or loss should be recognized by the transferor when paragraph 55 is applied.

Issue 2—How assets re-recognized by the transferor that were previously sold to an SPE that was formerly considered qualifying should be accounted for when the entire SPE becomes nonqualifying under the provisions of paragraph 55, including whether any gain or loss should be recognized by the transferor when paragraph 55 is applied.

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

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

Issue 5—After a paragraph 55 event, how the transferor should account for its retained interest (other than the servicing asset).

Prior EITF Discussion

5. At the September 11–12, 2002 EITF meeting, the Task Force discussed Issue 1 but was not able to reach a consensus. The Task Force asked the FASB staff to provide additional examples to show how other assets or liabilities (such as servicing) would be affected by the re-recognition of assets under paragraph 55. Also, the Task Force asked the FASB staff to clarify what the effect of re-recognition should be on the retained beneficial interest. Specifically, the Task

[2] GNMA ROAPs are actually held by the servicer of the transferred loans. However, when the servicer is the transferor, the provisions of Statement 140 apply to the ROAP.

Force asked the FASB staff to further consider whether changes in the fair value of a retained interest that result prior to re-characterization from, for example, a security to a loan should be (a) included in the new carrying amount of the loan or (b) eliminated from accumulated other comprehensive income (if previously accounted for as an available-for-sale security) or income (if previously accounted for as a trading security) when paragraph 55 is applied. The Task Force also asked the FASB staff to clarify whether a re-recognition pursuant to paragraph 55 should cause the transferor to evaluate the retained beneficial interest for impairment.

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

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

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

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

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

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

Current EITF Discussion

12. At the March 20, 2003 EITF meeting, the Task Force reached a consensus on Issue 2 that in the event the entire SPE becomes nonqualifying upon application of paragraph 55, no gain or loss should be recognized with respect to the "repurchase" by the transferor of the financial assets originally sold that remain outstanding in the SPE (or the portion thereof if the transferor retained a partial interest in those assets). The fair value of the re-recognized assets will equal the fair value of the liability assumed by the transferor because the transferor is contractually required to pass on 100 percent of the cash flows from the re-recognized assets to the SPE for distribution in accordance with the contractual documents governing the SPE. The process of determining the fair value of both the re-recognized assets and the assumed liability may require a careful analysis of all of the expected cash flows of the securitization vehicle, including cash flows of assets within the vehicle that are not subject to paragraph 55 (for example, proceeds that are temporarily reinvested by the SPE). In performing that analysis, the transferor would need to consider both the timing and the amounts of the expected cash flows and also which party has rights to such expected cash flows at the time of the paragraph 55 event.

13. The Task Force reached a consensus on Issue 4 that when a paragraph 55 event occurs, the accounting for the servicing asset related to the previously sold financial assets does not change as a result of the application of paragraph 55. That is, even though the transferor has regained control over the previously sold assets, the cash flows from those assets will contractually be paid to the SPE, which will then distribute the proceeds to satisfy its contractual obligations (including obligations to the beneficial interest holders). Because the transferor, as servicer, is still contractually required to collect the asset's cash flows for the benefit of the SPE and otherwise service the assets, it should continue to recognize the servicing asset and assess the asset for impairment as required by Statement 140.

14. The Task Force reached a consensus on Issue 5 that when a paragraph 55 event occurs, the transferor should continue to account for its retained interest in those assets apart from any re-recognized assets. That is, the retained interest should not be combined with and accounted for with the same as the re-recognized assets. However, a subsequent event that results in the transferor reclaiming those assets from the transferee—for example, the exercise of a ROAP or the consolidation by the transferor of the SPE in accordance with applicable generally accepted accounting principles, including Interpretation 46—would result in a recombination of the retained interest with the underlying assets.

15. The consensuses in this Issue should be applied prospectively to paragraph 55 events occurring after April 2, 2003.

16. Examples illustrating the application of the consensuses in this Issue will be provided at a later date.

Board Ratification

17. At its April 2, 2003 meeting, the Board ratified the consensuses reached by the Task Force in this Issue.

Status

18. No further EITF discussion is planned.

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

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

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

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

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

FASB 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*

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

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

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

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

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

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

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

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

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

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

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

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

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

Introduction

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

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

3. As a result of rights received through an investment vehicle, an investor may gain the ability to exercise significant influence over the operating and financial policies of an investee[2] without

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

[2] Refer to paragraph 17 of Opinion 18 and paragraph 4 of Interpretation 35.

holding an investment in voting common stock of the investee. Some believe that existing authoritative literature already addresses an investors' 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.

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.

[3] EITF Agenda Committee background material for May 1998.

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.

Current EITF Discussion

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:

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

[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.

[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).

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.

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

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[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.

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 might 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).

Status

15. Further discussion is expected at a future meeting.

[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."

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

AICPA Auditing Guide, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

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

AICPA Audit and Accounting Guide, *Health Care Organizations*

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

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

International Accounting Standard 36, *Impairment of Assets*

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

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

Introduction

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

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

Issues

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

Prior EITF Discussion

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

5. 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.

6. 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.

Current EITF Discussion

7. 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 date of the financial statements).

8. 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). Step 1 also provides that, for investments with no readily determinable fair value, the fair value of the investment should be measured when an impairment indicator is present.

9. 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, if an investment has been impaired for one year, it would be unlikely 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. That one-year period, however, is not intended to be a “brightline” for purposes of determining whether an impairment is other than temporary.

10. 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 (that is, a decline in its fair value is due only to interest rate fluctuations).

11. 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.

Status

12. Further discussion is expected at a future meeting.

Issue No. 03-4

Title: Accounting for "Cash Balance" Pension Plans

Date Discussed: March 20, 2003

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

FASB Special Report, *A Guide to Implementation of Statement 87 on Employers' Accounting for Pensions: Questions and Answers*

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

Introduction

1. In recent years, so-called hybrid pension plans have become more popular among employers. Typically, those arrangements describe the pension benefit by reference to an account balance rather than a monthly annuity at retirement. Such plans are often referred to as "cash balance pension plans" (or cash balance plans). For purposes of this Issue, a cash balance plan provides a pension benefit in the form of an account balance based on principal credits and interest credits over time based on those principal credits. Authoritative literature does not address arrangements of the specific nature of those in question.

Issues

2. The issues are:

Issue 1—Whether, for the purposes of applying Statement 87, cash balance plans should be considered defined benefit plans or defined contribution plans

Issue 2—If cash balance plans are determined to be defined benefit plans, what the appropriate expense recognition model should be.

Current EITF Discussion

3. At the March 20, 2003 EITF meeting, the Task Force reached a tentative conclusion on Issue 1 that cash balance plans should be considered defined benefit plans for purposes of applying Statement 87. In light of the definitions of defined contribution plans and defined benefit plans in Statement 87, the Task Force based that conclusion on the following attributes of cash balance plans:

- A cash balance plan defines the amount of pension benefit to be provided as a function of principal credits based on salary and future interest credits thereon at a stated rate.[1]

[1] Paragraph 11 of Statement 87 states, "For purposes of this Statement, a defined benefit pension plan is one that defines an amount of pension benefit to be provided, usually as a function of one or more factors such as age, years of service, or compensation."

- An employer's financial obligation to the plan is not satisfied by making prescribed principal and interest credit contributions—whether in cash or as a hypothetical contribution to participants' accounts—for the period; rather, the employer must fund, over time, amounts that can accumulate to the actuarial present value of the benefit due at the time of distribution to each participant pursuant to the plan's terms.
- A defined contribution plan, under Statement 87, is a plan that provides an individual account for each participant and each participant's benefit is based solely on the assets invested and the return on those assets. In a cash balance plan, individual account balances are determined by reference to a hypothetical account rather than specific assets, and the benefit is dependent upon the employer's promised interest-crediting rate, not the actual return on plan assets. The definition of a defined benefit plan under Statement 87 includes any plan that is not a defined contribution plan.
- Employer contributions to a cash balance plan trust and the earnings on the invested plan assets are unrelated to the principal and interest credits to participants' hypothetical accounts.

4. On Issue 2, the Task Force did not reach any conclusions but directed the FASB staff to consider the question of whether cash balance plans are "pay-related" as that concept is defined in Statement 87 and the Special Report on employers' accounting for pensions. In considering that question, the Task Force asked the FASB staff to specifically consider whether Question 50 of the Special Report is applicable to cash balance plans. The Task Force also asked the FASB staff to consider examples of various plan features that would indicate when it is appropriate and necessary to depart from a plan's benefit formula in determining the attribution of benefits for accounting purposes.

Status

5. Further discussion is expected at a future meeting.

FASB EMERGING ISSUES TASK FORCE
Inventory of Open Issues
as of March 20, 2003

Issue Number	Issue	FASB Staff Assigned
98-4	Accounting by a Joint Venture for Businesses Received at Its Formation	Degano/ Munro
00-18	Accounting Recognition for Certain Transactions involving Equity Instruments Granted to Other Than Employees	Munro/ TBD
00-27	Application of EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," to Certain Convertible Instruments	Martin/ Richards
01-8	Determining Whether an Arrangement Contains a Lease	Lynn/ Parrott
01-11	Application of EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," to a Contemporaneous Forward Purchase Contract and Written Put Option	Martin/ Lynn
01-J	Accounting for the Deconsolidation of a Majority-Owned Subsidiary	Tovey/ TBD
02-14	Whether the Equity Method of Accounting Applies When an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means	Tovey/ Lynn
02-D	The Effect of Dual-Indexation both to a Company's Own Stock and to Interest Rates and the Company's Credit Risk in Evaluating the Exception under Paragraph 11(a)(1) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*	Martin/ Lynn
02-J	Interpretation of an "Unconstrained Right to Pledge or Exchange" Transferred Assets in a Collateralized Bond Obligation	TBD
02-L	Reporting Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and Not Held for Trading Purposes	Lynn/ Wilkins

Issue Number	Issue	FASB Staff Assigned
03-1	The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments	Tovey/ Lynn
03-3	Accounting for Claims-Made Insurance Policies by the Insured Entity	Degano/ Parrott/ Cropsey
03-4	Accounting for "Cash Balance" Pension Plans	Durbin/ Cassel
03-E	Determining Participating Securities and Allocation of Undistributed Earnings to Participating Securities under FASB Statement No. 128, *Earnings per Share*	TBD
03-F	Accounting Treatment of Emission Allowances Administered under the U.K. Emissions Trading Scheme	TBD

EMERGING ISSUES TASK FORCE AGENDA COMMITTEE
Open Agenda Committee Items

Item		Comment
Issue 00-N, "Measuring Fair Value of Equity Securities with Restrictions in a Nonmonetary Exchange"		Pending further progress by the Board on its project Measuring All Financial Assets and Liabilities at Fair Value.
Application of Issue No. 99-20 When a Special-Purpose Entity Holds Equity Securities and Whether an Investment That Is Redeemable at the Option of the Investor Should Be Considered an Equity Security or Debt Security		Pending consideration of an FASB project that may address the measurement of beneficial interests in securitized financial instruments.
Accounting for Investments in Limited Liability Companies		Pending FASB staff consideration of issues relating to the accounting for investors' interests in unconsolidated real estate investments.

FASB EMERGING ISSUES TASK FORCE
Description of Open Issues
as of March 20, 2003

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

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

Issue 00-27, "Application of EITF Issue No. 98-5, 'Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios,' to Certain Convertible Instruments." Issue 98-5 addresses the accounting for convertible securities with a nondetachable conversion feature that is in-the-money at the commitment date. That Issue also addresses certain convertible securities that have a conversion price that is variable based on future events. Subsequent to the consensus, a number of practical issues on the application of the guidance in Issue 98-5 have arisen.

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

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

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

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

Issue 02-D, "The Effect of Dual-Indexation both to a Company's Own Stock and to Interest Rates and the Company's Credit Risk in Evaluating the Exception under Paragraph 11(a)(1) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*." Paragraph 11(a) of Statement 133 provides that contracts issued or held by a reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position are not derivatives for purposes of applying Statement 133. EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock,'" addressed a number of common contractual provisions in which it was not clear whether the instrument met the condition of paragraph 11(a)(1) of Statement 133. However, some believe the guidance in that Issue does not apply with respect to dual indexation to a company's own stock and interest rates/credit risk given the provisions of Statement 133 with respect to convertible debt. The issue is whether instruments, other than convertible debt, that are indexed both to a company's own stock and to interest rates and the company's credit risk meet the condition in paragraph 11(a)(1) of Statement 133.

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

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

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

Issue 03-3, "Accounting for Claims-Made Insurance Policies by the Insured Entity." A claims-made insurance policy is one in which an entity is insured for any claims reported during the effective period of the policy. The claims may occur after the effective date of the policy and are reported while the policy is in force, or they may occur prior to the effective date of the policy and are reported while the policy is in force. *EITF Abstracts*, Topic No. D-79, "Accounting for Retroactive Insurance Contracts Purchased by Entities Other Than Insurance Enterprises," states that entities other than insurance enterprises should account for the purchase of retroactive insurance policies in a manner similar to the one in which reinsurance contracts are accounted for under FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*. When a claims-made policy is purchased with its prospective and retroactive components, the issue is whether an insured entity must apply Topic D-79 in all cases and, thus, always use the retroactive policy method of accounting described in Statement 113.

Issue 03-4, "Accounting for 'Cash Balance' Pension Plans." Cash balance plans are similar to defined contribution plans, however, most are hybrid arrangements with features of both defined contribution plans and defined benefit plans. The defined contribution features include the provision for lump sum distributions in the future based on stipulated contributions and interest credits. The defined benefit features include the provision of a life annuity, interest credits in excess of what may be obtainable in the market, joint and survivor options, and grandfathered or transitional defined benefit formulae. In addition, contributions and trust earnings are unrelated to contribution and interest credits. The presence of the defined benefit features, in general, makes it impractical to account for such arrangements as defined contribution plans because there is no way to segregate assets into defined contribution and defined benefit components and there are prior service costs and deferred gains or losses related to the defined benefit arrangement. In addition, most employers have chosen to classify plans as defined benefit or defined contribution based on the strict IRS definition that a defined contribution plan requires specific individual account balances, a condition that is not present in many "cash balance" arrangements. The issues are whether a cash balance plan should be accounted for as a defined benefit plan or a defined contribution plan, and if a cash balance plan should be accounted for as a defined benefit plan, what the appropriate pattern of benefit accruals is for a cash balance plan.

Issue 03-E, "Determining Participating Securities and Allocation of Undistributed Earnings to Participating Securities under FASB Statement No. 128, *Earnings per Share*." Statement 128 indicates that participating securities should be included in basic earnings per share (EPS), if the effect is dilutive, using either the two-class method or the if-converted method. Paragraph 60 of Statement 128 more fully describes participating securities through certain broad examples. Some convertible debt instruments have been issued with features that result in those securities being considered participating. For example, a convertible debt instrument that entitles the holder to participate in all dividends declared on common stock would result in that security being considered a participating security. However, some convertible debt instruments have been issued with certain other features and it is unclear based on the characteristics described in Statement 128 whether those securities should be considered to be participating securities. The issue is how to determine whether a security should be considered a "participating security" for purposes of computing EPS and how earnings should be allocated to a participating security when using the two-class method for computing basic EPS.

Issue 03-F, Accounting Treatment of Emission Allowances Administered under the U.K. Emissions Trading Scheme. The U.K. Emissions Trading Scheme (U.K. Scheme) has been introduced by the U.K. Government as a market mechanism designed to achieve Kyoto Protocol CO_2 reductions. Direct Participants in the U.K. Scheme are eligible for an Incentive Payment (Incentive Payment) at the end of each year of the U.K. Scheme. A Direct Participant can receive its yearly Incentive Payment if its emissions are below yearly Baseline targets (Baseline) set by the U.K. Government. The Incentive Payment is divided into equal yearly tranches. If the Direct Participant emits less than its Baseline for any given year, it receives the full yearly amount. If the Direct Participant emits above the Baseline in a given year, it does not receive an Incentive Payment in that year. Baseline targets for each year have been set through a competitive bidding process, where the Direct Participants agreed to a specific decrease in emissions as compared with the actual emissions in a period. Each Direct Participant is provided with tradeable CO_2 Allowances ("Allowances") for the upcoming year equal to the determined Baseline for that Direct Participant. At the end of each year, each Direct Participant must transfer Allowances to the ETA equal to the volume of its CO_2 emissions equivalent for that year. If the Direct Participant emits less than the Baseline, it will have surplus Allowances that can be either carried forward or sold into the market for Allowances. A Direct Participant can buy or sell Allowances at any point in time but must have sufficient allowances at the end of the year to support its transfer of credits to the ETA. The issue is whether those Allowances (or allowances under similar programs in other countries) are derivatives within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*