1102FN

FINANCIAL ACCOUNTING STANDARDS BOARD
401 Merritt 7, P.O. Box 5116
Norwalk, Connecticut 06856-5116
Telephone: 203-847-0700 *Fax*: 203-849-9714
Internet address: eitf@fasb.org or jnparrott@fasb.org

December 11, 2002

TO: MEMBERS OF THE FASB EMERGING ISSUES TASK FORCE

Included are the final minutes of the November 21, 2002 meeting of the FASB Emerging Issues Task Force, (a marked version of the November 26, 2002 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 02-16 Transition
The responses to the e-mail sent late Monday regarding transition for Issue 1 of Issue 02-16 resulted in varied responses from Task Force members. Accordingly, the FASB staff does not believe that providing comprehensive transition guidance in the attached final minutes is appropriate at this time. However, the final minutes for Issue 02-16 do provide that, for situations in which previously reported net income would not be impacted, reclassification of prior periods presented is required, unless it is impracticable to do so. Early application of the consensus is permitted in those situations. In situations in which prior period net income would be impacted, the FASB staff believes that precluding early application of the consensus sufficiently addresses the issue until the Task Force has the opportunity to comprehensively discuss transition for those situations at the January 23, 2003 meeting.

Issue 00-21 Scope Paragraph Example
In the draft minutes distributed to the Task Force, the FASB staff drafted a footnote to the scope paragraph (paragraph 4(a)) of Issue 00-21. The purpose of that footnote was to demonstrate the application of the related scope provisions through an example involving the sale of hardware, software, and post contract support services (PCS). Specifically, the intent of that example was to illustrate the interaction of SOP 97-2 (higher-level authoritative literature) and Issue 00-21 with respect to determining separate units of accounting in the arrangement and allocation of the arrangement consideration.

During the minutes process, however, the FASB staff received certain comments indicating that differing interpretations may exist with respect to the scope of SOP 97-2. That is, in the footnote example in which the software is more than incidental to the hardware, some believe that the entire arrangement is within the scope of SOP 97-2 and, therefore, that the example is not a valid illustration of the scope of Issue 00-21. As a result of those differing interpretations, that footnote has been deleted. The FASB staff considered whether another example should be developed. In that regard, there is concern that similar interpretation issues may arise with respect to including another example. Further, in the FASB staff's view, sufficient language has been provided in paragraph 4(a) to enable constituents to reasonably interpret and apply the related scope provisions. Accordingly, an example has not been included in the final minutes.

Meeting Time and Location

The next EITF meeting will be held on **Thursday, January 23, 2003**, at the FASB offices in Norwalk, Connecticut. 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.**

Minutes

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

Draft minutes available	**January 28, 2003**
Final minutes available	**February 6, 2003**

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

Sincerely,

James N. Parrott
Practice Fellow

1102FN

MINUTES OF THE NOVEMBER 21, 2002 OPEN MEETING OF THE FASB EMERGING ISSUES TASK FORCE

Location: FASB Offices
401 Merritt 7
Norwalk, Connecticut

Thursday, November 21, 2002

Starting Time:	8:00 a.m.
Concluding Time:	3:15 p.m.

Task Force Members Present:

Lawrence W. Smith (Chairman)
Frank H. Brod
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)
Jackson M. Day (SEC Observer)

Task Force Members Absent:

Leland E. Graul

Others at Meeting Table:

Robert H. Herz, FASB Board Member
* John M. Foster, FASB Board Member
Gary S. Schieneman, FASB Board Member
John K. Wulff, FASB Board Member
Francis E. Scheuerell, Jr., for Mr. Graul
Scott A. Taub, SEC Deputy Chief Accountant
Shelly C. Luisi, SEC Associate Chief Accountant
James N. Parrott, FASB Practice Fellow
* Halsey G. Bullen, FASB Senior Project Manager
* Brian F. Degano, FASB Practice Fellow
* Samuel O. Lynn, FASB Practice Fellow
* Vickie A. Lusniak, FASB Assistant Project Manager
* Gregory S. Martin, FASB Practice Fellow
* Lisa M. Munro, FASB Practice Fellow
* Daniel J. Slayton, FASB Practice Fellow
* Michael W. Tovey, FASB Practice Fellow

* For certain issues only.

ADMINISTRATIVE MATTERS

- The Task Force Chairman discussed the meeting dates for 2003. The FASB staff will attempt to reschedule the July and September meetings in light of certain conflicts with the proposed dates for those months. The Task Force approved the following meeting dates:

January 23, 2003
March 20, 2003
May 15, 2003
November 13, 2003.

- The Task Force Chairman announced that beginning with the January 2003 EITF Agenda Committee meeting, FASB Board members Katherine Schipper and Edward W. Trott will become Agenda Committee members. In addition, beginning with the January 23, 2003 EITF meeting, all EITF consensuses will be subject to FASB Board ratification. That ratification will occur at a public Board meeting approximately two weeks following each EITF meeting. *EITF Abstracts*, Topic No. D-1, "Implications and Implementation of an EITF Consensus," will be updated to reflect that development.

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

a. 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. The Task Force agreed to add this Issue to its agenda provided that other examples are provided to sufficiently narrow the related scope.

b. Issues Involving Step One of the Goodwill Impairment Test in FASB Statement No. 142, *Goodwill and Other Intangible Assets*. The Task Force agreed not to add this Issue to its agenda. The Task Force requested that the Board address the application of step one of the goodwill impairment test when a reporting unit has a negative carrying value.

c. The Task Force reviewed the EITF Open Issues and Open Agenda Committee Items. The Task Force agreed to remove from its agenda nine issues relating to revenue recognition. The revenue recognition issues were placed on the EITF agenda prior to the Board agreeing to add to its agenda a major project on the recognition of revenues and liabilities in financial statements. That project is intended to result in a comprehensive revenue recognition standard with the objectives of (a) eliminating the inconsistencies in the existing authoritative literature and accepted practices, (b) filling the voids that have emerged in revenue recognition guidance, and (c) providing guidance for addressing issues that arise in the future. The EITF Issues and Open Agenda Committee Items that will be removed from the agenda are:

No. 00-22, "Accounting for 'Points' and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future"

No. 00-24, "Revenue Recognition: Sales Arrangements That Include Specific-Price Trade-In Rights"
No. 01-4, "Accounting for Sales of Fractional Interests in Equipment"
No. 02-G, "Recognition of Revenue from Licensing Arrangements on Intellectual Property"
No. 00-x2, "Accounting for Front-End and Back-End Fees"
No. 00-x3, "Accounting for Access, Maintenance, and Publication Fees"
No. 00-x4, "Accounting for Advertising or Other Arrangements Where the Service Provider Guarantees a Specified Amount of Activity"
"Revenue Attribution in an Arrangement Including More-Than-Incidental Software and the Sale or Lease of Property, Plant, or Equipment"
"Accounting for Post-Contract Customer Support-Related Services on Software That Is Incidental to a Product or Service Offered by a Vendor."

During the course of its review, the Task Force also considered other agenda items for removal from the EITF agenda. The Task Force agreed to remove EITF Issue No. 02-1, "Balance Sheet Classification of Assets Received in Exchange for Equity Instruments," from its agenda due to a perceived lack of practice issues related to that topic. In addition, the Task Force agreed to remove EITF Issues No. 99-14, "Recognition by a Purchaser of Losses on Firmly Committed Executory Contracts," and No. 00-26, "Recognition by a Seller of Losses on Firmly Committed Executory Contracts." The Task Force observed that the accounting for executory contracts is an extremely broad topic with significant and pervasive implications on financial reporting. However, due to the lack of authoritative guidance on this subject, the Task Force requested the FASB staff to explore with the Board the possibility of a Board project to address executory contract accounting.

The Task Force also agreed to remove EITF Issues No. 00-20, "Accounting for Costs Incurred to Acquire or Originate Information for Database Content and other Collections of Information," and No. 00-x1, "Accounting for the Costs of Computer Files That Are Essentially Films, Music, or Other Content." The Task Force observed that those Issues involve a fundamental question regarding the definition of an asset and, therefore, would more appropriately be addressed by the Board.

- The Task Force discussed comment letters received on the following Issues:

a. EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables" (5 comment letters)[1]

b. 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" (2 comment letters)[1]

c. EITF Issue No. 02-12, "Permitted Activities of a Qualifying Special Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (4 comment letters).[1]

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

DISCUSSION OF THE MINUTES OF THE OCTOBER 25, 2002 MEETING

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

The FASB staff indicated that it has made the following changes to the minutes of this Issue (additions are underscored and deletions are struck through).

Paragraph 15 is revised as follows:

> The Task Force discussed physical inventories included in energy trading activities and noted that those inventories are often carried at fair value based on current industry practice. The Task Force agreed that its decision to rescind Issue 98-10 will eliminate any basis for recognizing physical inventories at fair value, except~~ other than~~ as provided by other guidance under higher categories of the GAAP hierarchy~~ Chapter 4 of ARB 43~~.

Paragraph 16 is revised as follows:

> 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 in the income statement, whether or not settled physically, if the derivative instruments are held for *trading purposes*.[2] 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.[3] ~~However, the FASB staff observes that, in its view, an entity should not recognize a dealer profit or unrealized gain or loss at inception of a derivative instrument unless the fair value of that instrument (in its entirety) is evidenced by quoted market prices or current market transactions.~~

[2] 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, ~~determining whether a derivative instrument continues to be held for "trading purposes" should also be consistent with the guidance previously provided in Issue 98-10 in that~~ reclassifications into and out of trading should be rare.

[3] The FASB staff observes that the definition of fair value provided in paragraph 540 of Statement 133 states that "if a quoted market price is not available, the estimate of fair value should be based

on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances." The FASB staff believes that, in the absence of (a) quoted market prices in an active market, (b) observable prices of other current market transactions, or (c) other observable data supporting a valuation technique, the transaction price represents the best information available with which to estimate fair value at the inception of the arrangement. Therefore, in the FASB staff's view an entity should not recognize an unrealized gain or loss at inception of a derivative instrument unless the fair value of that instrument is obtained from a quoted market price in an active market or is otherwise evidenced by comparison to other observable current market transactions or based on a valuation technique incorporating observable market data. For example, a valuation technique that includes extrapolated price curves with little or no observable market inputs for any significant duration of the instrument should not result in an initial fair value estimate that differs from the transaction price for the instrument taken as a whole, because, in this example, the transaction price is the best evidence of the instrument's fair value at that point in time.

DISCUSSION OF AGENDA TECHNICAL ISSUES

Issue No. 00-21

Title: Revenue Arrangements with Multiple Deliverables

Dates Discussed: July 19–20, 2000; September 20–21, 2000; November 15–16, 2000; January 17–18, 2001; April 18–19, 2001; July 19, 2001; November 14–15, 2001; January 23–24, 2002; March 20–21, 2002; June 19–20, 2002; September 11–12, 2002; October 25, 2002; November 21, 2002

References: FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*

FASB Statement No. 5, *Accounting for Contingencies*

FASB Statement No. 13, *Accounting for Leases*

FASB Statement No. 45, *Accounting for Franchise Fee Revenue*

FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*

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

FASB Statement No. 68, *Research and Development Arrangements*

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. 116, *Accounting for Contributions Received and Contributions Made*

FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*

FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

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

APB Opinion No. 20, *Accounting Changes*

AICPA Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*

AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*

AICPA Statement of Position 97-2, *Software Revenue Recognition*

AICPA Statement of Position 98-9, *Modification of SOP 97-2,* Software Revenue Recognition, *With Respect to Certain Transactions*

AICPA Statement of Position 00-2, *Accounting by Producers or Distributors of Films*

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

SEC Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers*

Introduction

1. Many companies offer multiple solutions to their customers' needs. Those solutions may involve the delivery or performance of multiple products, services, or rights to use assets, and performance may occur at different points in time or over different periods of time. In many cases, the arrangements include initial installation, initiation, or activation services and involve consideration in the form of a fixed fee or a fixed fee coupled with a continuing payment stream. The continuing payment stream generally corresponds to the continuing performance, and the amount of the payments may be fixed, variable based on future performance, or a combination of fixed and variable payment amounts.

2. This Issue addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. In some arrangements, the different revenue-generating activities (deliverables) are sufficiently separable, and there exists sufficient evidence of their fair values to separately account for some or all of the deliverables (that is, there are separate units of accounting). In other arrangements, some or all of the deliverables are not independently functional, or there is not sufficient evidence of their fair values to account for them separately.

3. This Issue addresses when and, if so, how an arrangement involving multiple deliverables should be divided into separate units of accounting. This Issue does not change otherwise applicable revenue recognition criteria. Accordingly, this Issue does not address when the criteria for revenue recognition are met or provide guidance on the appropriate revenue recognition model for a given unit of accounting (regardless of whether that unit of accounting is an entire arrangement or an individual deliverable). For example, this Issue does not address when revenue attributable to a given unit of accounting should be recognized based on proportional performance. The timing of revenue recognition for a given unit of accounting will depend on the nature of the deliverable(s) in that accounting unit (and the corresponding revenue recognition model) and whether the general conditions for revenue recognition have been met. However, this Issue does provide guidance with respect to the effect of certain customer rights due to vendor nonperformance on the recognition of revenue allocated to delivered units of accounting. This Issue also addresses the impact on the measurement and/or allocation of arrangement consideration of customer cancellation provisions and consideration that varies as a result of future actions of the customer or the vendor. Finally, this Issue provides guidance with respect to the recognition of the cost of certain deliverables that are excluded from the revenue accounting for an arrangement.

4. This Issue applies to all deliverables (that is, products, services, or rights to use assets) within contractually binding arrangements (whether written, oral, or implied, and hereinafter referred to as "arrangements") in all industries under which a vendor will perform multiple revenue-generating activities, except as follows:

a. To the extent that a deliverable(s) in an arrangement is within the scope of other existing higher-level authoritative literature that provides guidance on whether and/or how to separate multiple-deliverable arrangements and how to allocate value among those separate units of accounting (including, but not limited to, Statements 13, 45, and 66; and SOPs 81-1, 97-2, and 00-2), that deliverable(s) should be accounted for in accordance with that literature. However, if that arrangement also includes a deliverable(s) that is *not* within the scope of such higher-level literature, this Issue should be applied to determine (1) whether that deliverable(s) represents a separate unit of accounting from the deliverable(s) that is within the scope of other higher-level literature and, if so, (2) how to allocate the arrangement consideration to the separate units of accounting, unless the higher-level literature provides guidance with respect to (1) or (2), above, for the deliverable(s) that is not otherwise in the scope of the higher-level literature.

b. Arrangements that include vendor offers to a customer for either (1) free or discounted products or services that will be delivered (either by the vendor or by another unrelated entity) at a future date if the customer completes a specified cumulative level of revenue transactions with the vendor or remains a customer of the vendor for a specified time period or (2) a rebate or refund of a determinable cash amount if the customer completes a specified cumulative level of revenue transactions with the vendor or remains a customer of the vendor for a specified time period, are excluded from the scope of this Issue. Additionally, arrangements involving the sale of award credits by broad-based loyalty program operators are excluded from the scope of this Issue.

Issues

5. The issues are:

Issue 1—How to determine when an arrangement with multiple consists of more than one unit of accounting

Issue 2—If an arrangement consists of more than one unit of accounting, how the arrangement consideration should be allocated among the separate units of accounting

Issue 3—What effect, if any, certain customer rights due to vendor nonperformance have on the measurement of arrangement consideration and/or the allocation of consideration to the delivered unit(s) of accounting

Issue 4—How to account for direct costs incurred related to an arrangement that (a) are not associated with a specific deliverable or (b) are associated with a specific deliverable but that deliverable is required to be combined with another deliverable (or other deliverables)

Issue 5(a)—The impact, if any, of a customer's ability to cancel a contract and incur a cancellation penalty on the measurement of arrangement consideration

Issue 5(b)—The impact, if any, of consideration that varies as a result of future *customer* actions on the measurement and/or allocation of arrangement consideration

Issue 5(c)—The impact, if any, of consideration that varies as a result of future *vendor* actions on the measurement and/or allocation of arrangement consideration

Issue 6—The impact of a vendor's intent not to enforce its contractual rights in the event of customer cancellation on the measurement and/or allocation of arrangement consideration.

Prior EITF Discussion

6. At the July 19–20, 2000 meeting, the Task Force discussed the scope of this Issue. There was general agreement that guidance developed in this Issue on accounting for multiple-deliverable revenue arrangements should be comprehensive. However, due to the voluminous number of transactions and industries that would be impacted by an issue addressing the accounting for all multiple-deliverable revenue arrangements not covered by categories (a) and (b) of the GAAP hierarchy, the Task Force agreed that the Working Group formed to address this Issue should initially address this Issue in the context of a limited number of industry-specific multiple-element fact patterns. The Task Force also suggested that while considering the industry-specific fact patterns, the Working Group should request input from preparers within the specific industries. The Task Force was not asked to reach a consensus.

7. At the September 20–21, 2000 meeting, the Task Force discussed the general accounting model recommended by the Working Group for Issues 1 and 2 but was not asked to reach a consensus. That model provides that a deliverable in an arrangement should be segmented and accounted for separately from the remainder of the arrangement as an independent unit of accounting only if there is objective and reliable evidence of fair value to allocate the consideration to the separate deliverables in the arrangement and the deliverable meets at least one of the following criteria at the inception of the arrangement:

a. The deliverable does not affect the quality of use or the value to the customer of the other deliverables in the arrangement.

b. The deliverable can be purchased from another unrelated vendor without affecting the quality of use or the value to the customer of the remaining deliverables in the arrangement.

8. In discussing Issues 1 and 2, the Task Force generally agreed that the Working Group should consider whether certain types of deliverables are customer incentives rather than separate revenue-generating deliverables. Certain Task Force members expressed a view that when a deliverable is outside a vendor's ongoing major or central operations, the deliverable does not appear to be a revenue-generating deliverable and, accordingly, revenue should not be allocated to the deliverable. In considering this approach further, the Task Force requested that the Working Group consider whether the cost of the incentive represents an expense (for example, advertising or cost of goods sold) or a reduction to revenue related to the remaining deliverables in an arrangement.

9. The Task Force generally agreed that an inconsequential or perfunctory deliverable should not be required to be accounted for within the arrangement's revenue accounting. The Task Force also indicated that the Working Group should consider whether additional guidance should

be developed in order to determine what constitutes a deliverable. The Task Force observed that the impact of contract provisions on the accounting model proposed by the Working Group must be addressed.

10. The Task Force did not discuss in detail the general model or the examples of multiple-deliverable revenue arrangements provided in the Issue Summary. However, Task Force members were asked to provide comments to the FASB staff prior to the November 15–16, 2000 meeting on whether they agreed or disagreed with the Working Group's preliminary recommendations on the examples and the reasons for their views.

11. At the November 15–16, 2000 meeting, the Task Force discussed the Working Group's proposed criteria for determining whether certain deliverables in a multiple deliverable arrangement should be excluded from the revenue accounting for the arrangement. In other words, an excluded deliverable would not be included in the allocation of the arrangement fee. Rather, the excluded deliverable would be accounted for based on its cost to the vendor. The Task Force discussed the model proposed by the Working Group that would require all of the following conditions to be met in order for a deliverable to be excluded from the revenue accounting for the arrangement:

a. The vendor's incremental cost of providing the deliverable to the customer does not exceed 3 percent of the arrangement fee (the total fair value of all the deliverables in the transaction). If the customer is required to execute multiple transactions, that condition would be evaluated using the total fair value of the cumulative transactions required to be transacted by the customer in order to receive the deliverable under the vendor offer. In circumstances in which the vendor can reasonably estimate the relative percentage of customers who will not ultimately receive the deliverable, that estimate of "breakage" could be considered in the computation.

b. If the item being evaluated will not be provided to the customer by the time the first deliverable *within* the revenue arrangement is delivered, failure to deliver the item will not diminish the quality of use or the value to the customer of the other deliverables in the current exchange transaction. The quality of use or the value to the customer of the other deliverables in the transaction is not diminished if the deliverable can be purchased from another unrelated vendor.

c. Nonperformance with respect to the deliverable will not result in a refund or price concession in excess of the incremental cost to the vendor of that deliverable.

d. The vendor does not separately sell the deliverable.

12. The Task Force expressed a preference for a model that includes criteria (a)–(c), but not criterion (d). The SEC Observer stated a preference that criterion (d) be included in the model. In the event that criterion (d) is included in the model in some form, the Task Force expressed a preference that criterion (d) be addressed in a "second-tier" test that would allow a deliverable that is sold separately by the vendor to be accounted for at its cost if the deliverable is not significant to the arrangement. Most Task Force members believed that this condition should be

based on the relative fair value of the deliverable to the total arrangement fee. The Task Force did not agree on a "bright-line" percentage that would be used for that test and asked the Working Group to consider this issue further. Additionally, some Task Force members expressed a preference for modifying criterion (c) so that a deliverable that results in a refund obligation to the customer that is in excess of the cost of that deliverable to the vendor could still be accounted for based on its cost to the vendor provided that the obligation is not greater than 3 percent of the arrangement fee. The Task Force also requested that the Working Group consider whether the "incremental cost" measurement in criterion (a) is sufficiently operational and whether a "direct cost" measurement should be considered.

13. The Task Force discussed the impact of certain contract provisions on the accounting model. Specifically, the Task Force discussed whether the portion of the consideration allocated to delivered items should be considered collectible if it is subject to forfeiture, refund, or other concession (or if previously delivered items are returnable) if any of the undelivered items are not delivered. The Task Force generally agreed that a contractual provision that allows a customer to return a product if any of the undelivered items are not delivered is not fundamentally different from a general right of return and should be accounted for in a manner similar to rights of return under Statement 48. Further, a contractual provision that allows a customer to receive a refund or concession if any of the undelivered items are not delivered may be, in essence, a cancellation penalty (performance disincentive or liquidating damage provision) related to the remaining undelivered items. The Task Force requested that the FASB staff and the Working Group continue to develop this approach and the criteria that should be met in order to apply such an approach.

14. The Task Force observed that any consensuses on this Issue likely would influence any proposed answers on Issues 1, 2, 4, and 5 of EITF Issue No. 00-22, "Accounting for 'Points' and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future."

15. At the January 17–18, 2001 meeting, the Task Force continued to discuss the proposed criteria for determining whether certain deliverables in a multiple-deliverable arrangement should be excluded from the revenue accounting for the arrangement. The Task Force discussed the Working Group's proposed criteria, which incorporated the Task Force's recommendations from the November 15–16, 2000 meeting. As modified, the proposed criteria would require all of the following conditions to be met in order for a vendor to have the option to exclude a deliverable from the revenue accounting for the arrangement (application of the proposed criteria would be optional in that a vendor would not be precluded from adopting a consistent policy of including all deliverables in an arrangement in that arrangement's revenue accounting):

a. If the item being evaluated will not be provided to the customer by the time the other deliverables within the revenue accounting are delivered, failure to deliver the item will not diminish the quality of use or the value to the customer of the other deliverables in the arrangement. The quality of use or the value to the customer of the other deliverables in the arrangement is not diminished if the deliverable being evaluated can be purchased from another, unrelated vendor.

b. Any vendor obligation relating to nonperformance (failure to deliver the item being evaluated) would not result in a refund or price concession in excess of 3 percent of the arrangement fee (the total fair value of all the deliverables in the arrangement).

c. Neither the direct cost nor the fair value (as applicable) of the deliverable exceeds the following percentages:

(1) For deliverables that are not sold separately by the vendor, either (a) the vendor's direct cost of providing the deliverable to the customer does not exceed 3 percent of the arrangement fee or (b) the fair value of the deliverable (if determinable) does not exceed 5 percent of the arrangement fee. Direct cost should consider external costs of materials and services, and payroll costs for employees, that directly relate to providing the item in question.

(2) For deliverables that are sold separately by the vendor, the fair value of the deliverable does not exceed 5 percent of the arrangement fee.

If the customer is required to execute multiple transactions, the condition would be evaluated using the total fair value of the cumulative transactions required to be transacted by the customer in order to receive the deliverable under the vendor offer. If a vendor can reasonably estimate the relative percentage of customers who will not accept or redeem the offer for the deliverable, that estimate of "breakage" could be considered in the computation.

16. The Task Force also discussed certain other observations and questions with respect to the proposed criteria. Task Force members agreed that the relative-size test as described in paragraph 15(c) should be applied as an aggregate limit for excluded deliverables and that in determining whether deliverables could be excluded from the revenue accounting for the arrangement, companies would be required to adopt a consistent policy of applying the proposed criteria.

17. The Task Force expressed support for the proposed criteria discussed in paragraph 15; however, the SEC staff expressed its concerns that the proposed criteria (a) include an arbitrary size test that does not reflect the economics of some business transactions, and (b) allow for revenue recognition for refundable arrangement fees. The Task Force requested that the Working Group continue to develop the provisions of the overall model for accounting for revenue arrangements with multiple deliverables.

18. At the April 18–19, 2001 meeting, the Task Force discussed the proposed model for determining when a revenue arrangement for multiple deliverables would be divided into separate units of accounting and, if separation is appropriate, how the arrangement consideration would be allocated to the identified accounting units (Issues 1 and 2). The components of the model presented by the Working Group to the Task Force were assembled from prior discussions for this Issue.

19. One component of the proposed model set forth conditions for when a deliverable in an arrangement could be excluded from the revenue accounting for that arrangement. Those

conditions were discussed at the January 17–18, 2001 meeting and are included in paragraph 15, above. At that meeting, the SEC staff expressed its concern that the proposed criteria included an arbitrary size test that may not reflect the economics of some transactions.

20. At the April 18–19, 2001 meeting, the Task Force modified the proposed model to address ongoing concerns about the conditions to be met in order for a deliverable to be excluded from the revenue accounting for an arrangement. The revised conditions are based in part on the guidance in SAB 101 and the SAB 101 FAQ for when a remaining performance obligation is inconsequential or perfunctory. In light of the change to this component of the model, the Task Force concluded that the scope of the Issue should exclude revenue arrangements that include an offer by a vendor for "free" or discounted products or services if the customer transacts a specified volume of future purchases with the vendor or remains a customer for a specified period of time (that is, arrangements within the scope of Issue 00-22). For those arrangements, the development of a specific accounting model that is consistent with the overall model discussed herein, will be considered separately.

21. The Task Force also discussed additional guidance proposed by the Working Group regarding the impact of contractual provisions on the allocation of arrangement consideration to the identified units of accounting. The Task Force generally agreed with the Working Group's proposal. However, during the discussion, the Task Force added additional guidance to the factors that would impair a vendor's ability to estimate refunds, revenue reversals, or concessions resulting from nonperformance under an arrangement.

22. At the July 19, 2001 meeting, the Task Force discussed another revised approach for determining when a revenue arrangement with multiple deliverables should be divided into separate units of accounting and, if separation is appropriate, how the arrangement consideration should be allocated to the identified accounting units. The Task Force was not asked to reach a consensus. The Task Force expressed general support for the revised approach but noted some redundancies in the model and some areas that require further clarification and additional work. The Task Force expressed support for eliminating cross-references to other literature in the model and, instead, including the relevant guidance from other literature within any final abstract. The Task Force generally agreed that further guidance or clarification is needed particularly regarding the criteria with respect to separate earnings process and essential to the functionality. The Task Force also discussed the need to eliminate certain guidance pertaining to revenue recognition rather than to separation of arrangement deliverables into units of accounting.

23. In a letter to the EITF dated July 19, 2001, the SEC Observer stated the SEC staff's view that developing guidance for revenue recognition related to multiple element arrangements is a broad project with many implications that is beyond the size and nature of a project contemplated by the mission of the Task Force. The SEC Observer also stated that although no such project has yet commenced, the SEC staff would object to a consensus on this Issue pending completion of a comprehensive revenue recognition standard subject to full due process. Accordingly, any future discussion would not be applicable to SEC registrants. Until further standards are developed, SEC registrants should disclose their accounting policy for revenue

recognition. In addition, the SEC staff would not object to an SEC registrant's accounting provided it complied with the broad principles in SAB 101 and the related SAB 101 FAQ.

24. The Task Force agreed to continue to work on the model for Issues 1, 2, and 3 with the objective of providing additional guidance for private companies and with the understanding that the FASB staff may propose that the FASB issue a Technical Bulletin (based on the model developed by the Task Force) addressing those Issues. The Task Force instructed the FASB staff to continue to develop examples to be included in the final materials for this Issue to illustrate the application of the various aspects of the model.

25. At the November 14–15, 2001 meeting, the Task Force discussed whether to continue work on this Issue and Issue 00-22. The SEC Observer stated that the SEC staff would support a decision by the Task Force to continue work on those Issues. The SEC Observer also stated that the SEC staff continues to be supportive of the FASB pursuing a broad project on revenue recognition. The Task Force discussed the advantages and disadvantages of providing guidance in this Issue and Issue 00-22 prior to the development of a comprehensive revenue recognition framework by the FASB and agreed that providing guidance on those Issues prior to completion of such a project would improve financial reporting. The Task Force agreed to first continue work on Issue 00-21 and that a decision on whether to continue further work on Issue 00-22 would be made after a consensus is reached on Issue 00-21.

26. At the January 23–24, 2002 meeting, the Task Force discussed changes to the proposed model suggested by the Working Group and others. Those revisions are reflected in a revised draft abstract in Exhibit 00-21A of the minutes for the January 23-24, 2002 meeting. The Task Force discussed the most significant of those changes as listed below and generally agreed with the suggested changes to the proposed model. The Task Force was not asked to reach any consensuses or tentative conclusions. (Paragraph references are to paragraph numbers in Exhibit 00-21A of the minutes for the January 23-24, 2002 meeting.)

a. Paragraph 4. The model discussed at the July 19, 2001 meeting included a scope exclusion for equipment sold on an installed basis. That is, even when equipment sold on an installed basis met the requirements to be divided into multiple units of accounting (equipment and installation), the model allowed the arrangement to be accounted for as a single unit of accounting. The Task Force expressed a preference for eliminating that scope exclusion.

b. Paragraphs 7–9. The model discussed at the July 19, 2001 meeting included the unavailability of the undelivered item from a third-party vendor as an indicator that the undelivered item is *essential to the functionality* of the delivered item. The Task Force expressed a preference for modifying the *essential to the functionality* criterion to indicate that the fact that a deliverable is readily available from a third party or can be performed by the customer overcomes the fact that the deliverable is essential to the functionality of other deliverables in the arrangement.

c. Paragraph 7. The Task Force observed that if a delivered item(s) meets both criteria to be a separate unit of accounting (refer to paragraph 30, below), the delivered item(s) represents a separate earnings process. Therefore, the Task Force expressed a preference for eliminating the *separate earnings process* criterion in order to qualify as a separate unit of accounting. An observation has been added that if both criteria of paragraph 7 are met, the delivered item(s) represents a separate earnings process.

d. Paragraph 9. The Task Force expressed a preference for eliminating the comparison of the cost or fair value of a deliverable to the gross profit (of the enterprise) and operating income (of the enterprise) as an indicator of whether the deliverable is *inconsequential or perfunctory*. The Task Force observed that such comparisons are not relevant and would seldom, if ever, indicate that a deliverable is significant if the cost or fair value of the deliverable is insignificant in relation to the arrangement fee.

e. Paragraph 9. The Task Force expressed a preference for adding an observation that the conditions that must be met in order to exclude a deliverable from the revenue accounting for an arrangement should be evaluated in the aggregate for all of the deliverables to be excluded from the revenue accounting for the arrangement.

27. Although the Task Force generally agreed with the preferences discussed above, it also agreed that additional clarification is needed, particularly with respect to the concepts of *essential to the functionality* and *readily available from a third-party vendor*. The Task Force instructed the FASB staff and the Working Group to develop examples to further illustrate the application of those concepts.

28. The Task Force also discussed Issues 5 and 6. Those issues relate to the impact, if any, on the measurement and/or allocation of arrangement consideration arising from (a) customer cancellation provisions in an arrangement and consideration that varies as a result of actions of the customer or the vendor and (b) a vendor's intent not to enforce all of its contractual rights under an arrangement.

Impact of Customer Cancellation Provisions

29. On Issue 5(a), the Task Force reached a tentative conclusion that the measurement of revenue per period for the units of accounting in the arrangement should be limited to the measurement that results from assuming that cancellation of the contract will not occur. The Task Force further observed that the amount recorded as an asset for the excess of revenue recognized under the arrangement over the amount of cash received from the customer since the inception of the arrangement should not exceed the cancellation fee to which the vendor is entitled under the arrangement.

Impact of Variable Arrangement Consideration due to Customer or Vendor Actions

30. On Issue 5(b), the Task Force reached a tentative conclusion that the vendor should assume that customer actions will not result in any incremental consideration in measuring the arrangement consideration to be allocated to the units of accounting. That is, because any incremental consideration results from the actions of (and is therefore controlled by) the customer, the vendor cannot consider any potential incremental fees in the determination of total arrangement consideration.

31. On Issue 5(c), the Task Force reached a tentative conclusion that a vendor should estimate the impact of consideration that varies as a result of the *vendor's* future actions on the total arrangement consideration, based on historical experience and/or other objective, reliable, and verifiable evidence, if available. If sufficient objective, reliable, and verifiable evidence of the impact of consideration that varies as a result of the vendor's future actions is not available, the vendor should assume that its actions will not result in any incremental consideration in measuring the arrangement consideration to be allocated to the units of accounting.

Impact of Vendor Intent Not to Enforce Its Contractual Rights in the Event of Customer Cancellation

32. The Task Force discussed Issue 6 but was not asked to reach any conclusions. The Task Force asked the Working Group to discuss that Issue further and to illustrate the application of the alternative views.

33. At the March 20–21, 2002 meeting, the Task Force discussed three alternative models in addition to the model included in Exhibit 00-21A (of the minutes for the January 23–24, 2002 meeting). The three alternative models differ principally in their approach with respect to what represents a separate earnings process. One of the models views the earnings process in the context of the vendor's overall business environment (taking into consideration, for example, the activities of the vendor's competitors), another views the earnings process in the context of only the vendor's business, while the third views the earnings process in the context of each individual arrangement.

34. A majority of the Task Force expressed a preference for the model that views the earnings process in the context of each individual arrangement. Task Force members generally agreed that an approach to this Issue that results in the identification of the relevant general principles upon which the model is based and supplements those principles with limited detailed application guidance is preferable to an approach that results in extensive detailed rule-based guidance. The Task Force directed the FASB staff to compare and contrast the application of the alternative models through examples.

35. At the June 19–20, 2002 meeting, the Task Force discussed four alternative models. The Task Force expressed continuing support for its earlier tentative conclusions on Issues 4, 5(b), and 5(c). The Task Force also reached a tentative conclusion that the impact of consideration that varies as a result of the *vendor's* future actions should be allocated in proportion to all other consideration allocated to the deliverables in an arrangement. The Task Force also reached a tentative conclusion that the impact of general rights of return within the scope of Statement 48 should be evaluated after the arrangement consideration is allocated to any portion of the arrangement that is eligible for revenue recognition (that is, to any delivered unit of accounting that is eligible for revenue recognition).

36. The Task Force reemphasized the need to first focus on the issue of whether the deliverables in an arrangement can be separated for accounting purposes. However, Task Force members expressed an interest in further understanding the implications of separating deliverables on

revenue recognition. Task Force members generally agreed to focus future discussions on two models. Accordingly, the Task Force directed the FASB staff to further evaluate the impact of those models on the separation of deliverables for certain examples. The Task Force requested that the FASB staff also provide a revenue recognition analysis for the units of accounting identified in those examples.

37. At the September 11–12, 2002 meeting, the Task Force reached a tentative conclusion on an approach to be used to determine when a revenue arrangement for multiple deliverables should be divided into separate units of accounting and, if separation is appropriate, how the arrangement consideration should be allocated to the identified accounting units. That approach was exposed for public comment prior to the October 25, 2002 meeting.

38. At the October 25, 2002 meeting, the Task Force discussed numerous comments received during the exposure period. In response to those comments, the Task Force reached a tentative conclusion on a revised model and agreed that that model should be exposed for public comment prior to the November 21, 2002 meeting. A draft abstract reflecting the revised model was provided in that regard.

Current EITF Discussion

39. At the November 21, 2002 meeting, the Task Force reached a consensus that the model in Exhibit 00-21A should be used to determine when a revenue arrangement with multiple deliverables should be divided into separate units of accounting and, if separation is appropriate, how the arrangement consideration should be allocated to the identified accounting units.

Status

40. No further EITF discussion is planned.

Exhibit 00-21A

EITF Abstracts

Issue No. 00-21

Title: Revenue Arrangements with Multiple Deliverables

Dates Discussed: July 19–20, 2000; September 20–21, 2000; November 15–16, 2000; January 17–18, 2001; April 18–19, 2001; July 19, 2001; November 14–15, 2001; January 23–24, 2002; March 20–21, 2002; June 19–20, 2002; September 11–12, 2002; October 25, 2002; November 21, 2002

References: FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*

FASB Statement No. 13, *Accounting for Leases*

FASB Statement No. 45, *Accounting for Franchise Fee Revenue*

FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*

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

FASB Statement No. 68, *Research and Development Arrangements*

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

FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*

FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

APB Opinion No. 20, *Accounting Changes*

AICPA Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*

AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*

AICPA Statement of Position 97-2, *Software Revenue Recognition*

AICPA Statement of Position 98-9, *Modification of SOP 97-2,* Software Revenue Recognition, *With Respect to Certain Transactions*

AICPA Statement of Position 00-2, *Accounting by Producers or Distributors of Films*

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

SEC Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers*

ISSUE

1. Many companies offer multiple solutions to their customers' needs. Those solutions may involve the delivery or performance of multiple products, services, or rights to use assets, and performance may occur at different points in time or over different periods of time. In some cases, the arrangements include initial installation, initiation, or activation services and involve consideration in the form of a fixed fee or a fixed fee coupled with a continuing payment stream. The continuing payment stream generally corresponds to the continuing performance, and the amount of the payments may be fixed, variable based on future performance, or a combination of fixed and variable payment amounts.

2. This Issue addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. Specifically, this Issue addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting. 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. This Issue also addresses how arrangement consideration should be measured and allocated to the separate units of accounting in the arrangement.

3. This Issue does not address when the criteria for revenue recognition are met or provide guidance on the appropriate revenue recognition convention for a given unit of accounting. For example, this Issue does not address when revenue attributable to a unit of accounting should be recognized based on proportional performance. The timing of revenue recognition for a given unit of accounting will depend on the nature of the deliverable(s) composing that unit of accounting (and the corresponding revenue recognition convention) and whether the general conditions for revenue recognition have been met.

4. This Issue applies to all deliverables (that is, products, services, or rights to use assets) within contractually binding arrangements (whether written, oral, or implied, and hereinafter referred to as "arrangements") in all industries under which a vendor will perform multiple revenue-generating activities, except as follows:

a. To the extent that a deliverable(s) in an arrangement is within the scope of other existing higher-level authoritative literature that provides guidance on whether and/or how to separate multiple-deliverable arrangements and how to allocate value among those separate units of accounting (including, but not limited to, Statements 13, 45, and 66; Technical Bulletin 90-1;and SOPs 81-1, 97-2, and 00-2), that deliverable(s) should be accounted for in accordance with that literature. However, if that arrangement also includes a deliverable(s) that is *not* within the scope of such higher-level literature, this Issue should be applied to determine (1) whether that deliverable(s) represents a separate unit of accounting from the deliverable(s) that is within the scope of other higher-level literature and, if so, (2) how to allocate the arrangement consideration to the separate units of accounting, unless the higher-level literature provides guidance with respect to (1) or (2), above, for the deliverable(s) that is not otherwise in the scope of the higher-level literature. The literature to be applied first is that which is applicable to the first delivered item(s).

b. Arrangements that include vendor offers to a customer for either (1) free or discounted products or services that will be delivered (either by the vendor or by another unrelated entity) at a future date if the customer completes a specified cumulative level of revenue transactions with the vendor or remains a customer of the vendor for a specified time period or (2) a rebate or refund of a determinable cash amount if the customer completes a specified cumulative level of revenue transactions with the vendor or remains a customer of the vendor for a specified time period, are excluded from the scope of this Issue. Additionally, arrangements involving the sale of award credits by broad-based loyalty program operators are excluded from the scope of this Issue.

5. The issues are:

Issue 1—How to determine whether an arrangement with multiple deliverables consists of more than one unit of accounting

Issue 2—If an arrangement consists of more than one unit of accounting, how the arrangement consideration should be allocated among the separate units of accounting

Issue 3—What effect, if any, certain customer rights due to vendor nonperformance have on the measurement of arrangement consideration and/or the allocation of consideration to the delivered unit(s) of accounting

Issue 4—How to account for direct costs incurred related to an arrangement that (a) are not associated with a specific deliverable or (b) are associated with a specific deliverable but that deliverable is required to be combined with another deliverable (or other deliverables)

Issue 5(a)—The impact, if any, of a customer's ability to cancel a contract and incur a cancellation penalty on the measurement of arrangement consideration

Issue 5(b)—The impact, if any, of consideration that varies as a result of future *customer* actions on the measurement and/or allocation of arrangement consideration

Issue 5(c)—The impact, if any, of consideration that varies as a result of future *vendor* actions on the measurement and/or allocation of arrangement consideration

Issue 6—The impact of a vendor's intent not to enforce its contractual rights in the event of customer cancellation on the measurement and/or allocation of arrangement consideration.

EITF DISCUSSION

6. In an arrangement with multiple deliverables, the Task Force reached a consensus that the principles in paragraph 7 and application guidance in paragraphs 8–17 should be used to

determine (a) how the arrangement consideration should be measured, (b) whether the arrangement should be divided into separate units of accounting, and (c) how the arrangement consideration should be allocated among the separate units of accounting. Examples illustrating the application of the principles and application guidance in this Issue are included in Appendix 00-21B.

Principles

7. The principles applicable to this Issue are:

- Revenue arrangements with multiple deliverables should be divided into separate units of accounting if the deliverables in the arrangement meet the criteria in paragraph 9.

- Arrangement consideration should be allocated among the separate units of accounting based on their relative fair values (or as otherwise provided in paragraph 12). The amount allocated to the delivered item(s) is limited as discussed in paragraph 14.

- Applicable revenue recognition criteria should be considered separately for separate units of accounting.

Application Guidance

Units of Accounting (Issue 1)

8. A vendor should evaluate all deliverables in an arrangement to determine whether they represent separate units of accounting. That evaluation must be performed at the inception of the arrangement and as each item in the arrangement is delivered.

9. In an arrangement with multiple deliverables, the delivered item(s) should be considered a separate unit of accounting if all of the following criteria are met:

a. The delivered item(s) has value to the customer on a standalone basis. That item(s) has value on a standalone basis if it is sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basis. In the context of a customer's ability to resell the delivered item(s), the Task Force observed that this criterion does not require the existence of an observable market for that deliverable(s).

b. There is objective and reliable evidence of the fair value of the undelivered item(s).

c. If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.

Refer to the flowchart in Appendix 00-21A for an illustration of the above criteria. The criteria for dividing an arrangement into separate units of accounting should be applied consistently to arrangements with similar characteristics and in similar circumstances.

10. The arrangement consideration allocable to a delivered item(s) that does not qualify as a separate unit of accounting within the arrangement should be combined with the amount allocable to the other applicable undelivered item(s) within the arrangement. The appropriate recognition of revenue should then be determined for those combined deliverables as a single unit of accounting.

Measurement and Allocation of Arrangement Consideration (Issues 2, 3, 5(a), 5(b), 5(c), and 6)

11. The amount of total arrangement consideration must be fixed or determinable other than with respect to the impact of (a) any refund rights or other concessions (hereinafter collectively referred to as "refund rights") to which the customer may be entitled or (b) performance bonuses to which the vendor may be entitled.

12. If there is objective and reliable evidence of fair value (as discussed in paragraph 16) for all units of accounting in an arrangement, the arrangement consideration should be allocated to the separate units of accounting based on their relative fair values (the relative fair value method), except as specified in paragraph 13. However, there may be cases in which there is objective and reliable evidence of the fair value(s) of the undelivered item(s) in an arrangement but no such evidence for the delivered item(s). In those cases, the residual method should be used to allocate the arrangement consideration. Under the residual method, the amount of consideration allocated to the delivered item(s) equals the total arrangement consideration less the aggregate fair value of the undelivered item(s). The "reverse" residual method (that is, using a residual method to determine the fair value of an undelivered item) is not an acceptable method of allocating arrangement consideration to the separate units of accounting, except as described in paragraph 13.

13. To the extent that any separate unit of accounting in the arrangement (including a delivered item) is required under GAAP to be recorded at fair value (and marked to market each reporting period thereafter), the amount allocated to that unit of accounting should be its fair value. Under those circumstances, the remainder of arrangement consideration should be allocated to the other units of accounting in accordance with the requirements in paragraph 12.

14. The amount allocable to a delivered item(s) is limited to the amount that is *not* contingent upon the delivery of additional items or meeting other specified performance conditions (the noncontingent amount). That is, the amount allocable to the delivered item(s) is the lesser of the amount otherwise allocable in accordance with paragraphs 12 and 13, above, or the noncontingent amount. Additionally, although Statement 48 may impact the amount of revenue recognized, the allocated amount is not adjusted for the impact of a general right of return pursuant to that Statement.

15. The Task Force reached a consensus that the measurement of revenue per period should be limited to the measurement that results from assuming that cancellation of the arrangement will not occur. The Task Force observed that the amount recorded as an asset for the excess of revenue recognized under the arrangement over the amount of cash or other consideration received from the customer since the inception of the arrangement should not exceed all amounts to which the vendor is legally entitled, including cancellation fees (in the event of customer cancellation). However, the Task Force further observed that whether a vendor intends to enforce its contractual rights in the event of customer cancellation should be considered in determining the extent to which an asset should be recorded.

16. Contractually stated prices for individual products and/or services in an arrangement with multiple deliverables should *not* be presumed to be representative of fair value. The best evidence of fair value is the price of a deliverable when it is regularly sold on a standalone basis. Fair value evidence often consists of entity-specific or vendor-specific objective evidence (VSOE) of fair value. As discussed in paragraph 10 of SOP 97-2, VSOE of fair value is limited to (a) the price charged for a deliverable when it is sold separately or (b), for a deliverable not yet being sold separately, the price established by management having the relevant authority (it must be probable that the price, once established, will not change before the separate introduction of the deliverable into the marketplace). The use of VSOE of fair value is preferable in all circumstances in which it is available. Third-party evidence of fair value (for example, prices of the vendor's or any competitor's largely interchangeable products or services in sales to similarly situated customers) is acceptable if VSOE of fair value is not available.

Accounting for Direct Costs in an Arrangement with Multiple Deliverables (Issue 4)

17. The Task Force agreed not to provide guidance on Issue 4 due to the broad, general nature of the question and its applicability beyond arrangements involving multiple deliverables. As such, this Issue does not address the allocation of direct costs in an arrangement.

Disclosure

18. A vendor should disclose (a) its accounting policy for recognition of revenue from multiple-deliverable arrangements (for example, whether deliverables are separable into units of accounting) and (b) the description and nature of such arrangements, including performance-, cancellation-, termination-, or refund-type provisions.

Transition

19. The guidance in this Issue is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Alternatively, entities may elect to report the change in accounting as a cumulative-effect adjustment in accordance with Opinion 20 and Statement 3. If so elected, disclosure should be made in periods subsequent to the date of initial application of this consensus of the amount of recognized revenue that was previously included in the cumulative effect adjustment. Early application of this consensus is permitted.

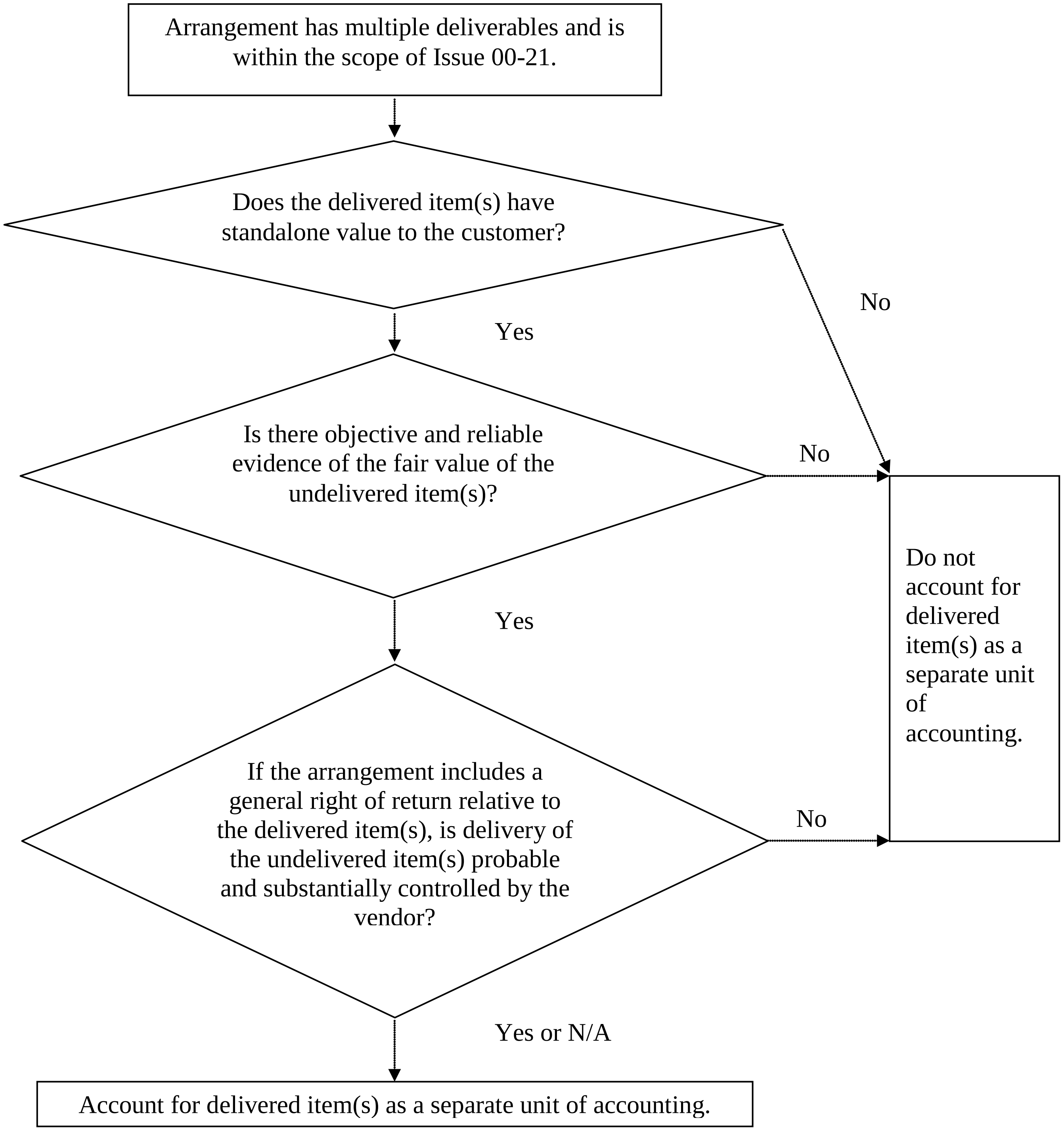
20. The SEC Observer commented that the SEC staff would review and revise SAB 101 and the SAB 101 FAQ, as necessary, to be consistent with the consensus in this Issue. In the interim, however, to the extent that the guidance in SAB 101 (and the SAB 101 FAQ) and Issue 00-21 conflict, the guidance in this Issue should be followed.

STATUS

21. No further EITF discussion is planned.

Appendix 00-21A

DETERMINING SEPARATE UNITS OF ACCOUNTING[1]


Arrangement has multiple deliverables and is within the scope of Issue 00-21.
Does the delivered item(s) have standalone value to the customer?
No
Yes
Is there objective and reliable evidence of the fair value of the undelivered item(s)?
No
Do not account for delivered item(s) as a separate unit of accounting.
Yes
If the arrangement includes a general right of return relative to the delivered item(s), is delivery of the undelivered item(s) probable and substantially controlled by the vendor?
No
Yes or N/A
Account for delivered item(s) as a separate unit of accounting.

[1] This diagram represents an overview of the provisions of this Issue with respect to determining the separate units of accounting in an arrangement and should, therefore, be reviewed in conjunction with the entire consensus.

Appendix 00-21B

EXAMPLES

Note: The examples below provide guidance *only* with respect to determining whether a multiple-deliverable revenue arrangement contains more than one unit of accounting and, if so, how to measure and allocate the arrangement consideration to the separate units of accounting. As discussed in paragraph 3, above, this Issue (including the examples below) does *not* address (for any unit of accounting) when the criteria for revenue recognition are met or provide guidance on the appropriate revenue recognition convention.

Example 1—Cellular Telephone Contract

CellularCo runs a promotion in which new customers who sign a two-year contract receive a "free" phone. The contract requires the customer to pay a cancellation fee of $300 if the customer cancels the contract. There is a one-time "activation fee" of $50 and a monthly fee of $40 for the ongoing service. The same monthly fee is charged by CellularCo regardless of whether a "free" phone is provided. The phone costs CellularCo $100. Further, assume that CellularCo frequently sells the phone separately for $120. CellularCo is not required to refund any portion of the fees paid for any reason. CellularCo is a sufficiently capitalized, experienced, and profitable business and has no reason to believe that the two-year service requirement will not be met. CellularCo is considering whether (a) the phone and (b) the phone service (that is, the airtime) are separable deliverables in the arrangement. The activation fee is simply considered additional arrangement consideration to be allocated. The phone and activation are delivered first, followed by the phone service (which is provided over the two-year period of the arrangement).

Evaluation: The first condition for separation is met for the phone. That is, the phone has value on a standalone basis because it is sold separately by CellularCo. The second condition for separation also is met because objective and reliable evidence of fair value exists for the phone service. Finally, there are no general rights of return in this arrangement. Therefore, the phone and the phone service should be accounted for as separate units of accounting.

The total arrangement consideration is $1,010. The fair value of the phone service is $960 ($40 × 24 months), the price charged by CellularCo. The fair value of the phone is $120, the price of the phone when sold separately by CellularCo. Without considering whether any portion of the amount allocable to the phone is contingent upon CellularCo's providing the phone service, CellularCo would allocate the arrangement consideration on a relative fair value basis as follows: $112.22 ($1,010 × [$120 ÷ ($120 + $960)]) to the phone and $897.78 ($1,010 × [$960 ÷ ($120 + $960)]) to the phone service. However, because a "free" phone is provided in the arrangement and the customer has no obligation to CellularCo if phone service is not provided, $62.22 (assuming the customer has paid the nonrefundable activation fee) is contingent upon CellularCo's providing the phone service. Therefore, the amount allocable to the phone is limited to $50 ($112.22 – $62.22), and the amount allocable to the phone service is increased to $960.

Example 2—Can Manufacturing Equipment

Company C sells high-speed aerosol can manufacturing equipment. Company C sells a complete manufacturing process, which consists of Equipment X, Y, and Z. Company C does not sell Equipment X, Y, and Z separately; however, other companies do sell the same equipment separately and there is a market for used equipment. Installation is not considered in this example.

Company C is evaluating revenue recognition under the following scenario:

> Company C delivered Equipment X and Z on March 27, but did not deliver Equipment Y until April 6. Without Equipment Y, the customer does not have use of Equipment X and Z. However, there is an active market for new Equipment X, Y, and Z on a separate basis, as the equipment is often bought separately from other vendors as replacements become necessary. The contract provides that if all pieces of equipment are not delivered, the customer may return Equipment X and Z and have no liability to Company C. The contract requires delivery of all equipment prior to June 1, and Company C has sufficient production capacity and inventory to deliver all of the equipment prior to that contractual deadline.

Evaluation: The first condition for separation is met for Equipment X and Z. Equipment X and Z have value on a standalone basis because they are sold separately by other vendors. The second condition for separation is also met because sufficient objective and reliable evidence of the fair value exists for Equipment Y based on the prices charged for the separate pieces of equipment by other unrelated vendors. Finally, there is no general right of return in the arrangement. Therefore, Equipment X, Y, and Z should be accounted for as separate units of accounting. However, even though accounted for as separate units of accounting, the arrangement consideration allocable to both Equipment X and Z is $0 because the full amount otherwise allocable to those separate deliverables is contingent upon the delivery of Equipment Y.

Example 3—Standard Equipment and Installation

Company E is an experienced manufacturer of equipment used in the construction industry. Company E's products range from small to large individual pieces of automated machinery to complex systems containing numerous components. Unit selling prices range from $200,000 to $2.5 million. Unit selling prices are quoted inclusive of installation.

Each equipment model has standard performance specifications and is not otherwise customized for the specific needs of a buyer. Company E extensively tests the equipment against those specifications prior to shipment. The installation process does not involve changes to the features or capabilities of the equipment and does not require proprietary information about the equipment in order for the installed equipment to perform to specifications.

While there are others in the industry with sufficient knowledge about the installation process for the equipment, as a practical matter, most purchasers engage Company E to perform the installation services. However, some customers choose not to have the equipment installation performed by Company E for various reasons (for example, their proprietary use of the equipment, their preference that installation be performed by their own employees or other vendors with whom the customers have established relationships, or for their own convenience). If a potential customer wishes to purchase equipment without installation, Company E will not reduce the quoted selling price for the commensurate value of the installation. If a customer chooses to purchase equipment without installation, there is only one deliverable.

Assume that a customer enters into an arrangement to purchase equipment with a price of $200,000 from Company E and chooses to have Company E perform the installation for that equipment. The customer is obligated to pay Company E the arrangement consideration upon delivery of the equipment. The price of the installation service when it is performed by vendors other than Company E is $8,000. There are no refund rights (general or otherwise) in the arrangement. Company E is considering whether (a) the equipment and (b) the installation service are separable units of accounting in the arrangement.

Evaluation: The first condition for separation is met for the equipment. The equipment has standalone value as it is sometimes sold separately by Company E. The second condition for separation is also met. Objective and reliable evidence of the fair value for the installation exists. There is sufficient evidence of the fair value of the installation on a separate component basis (as evidenced by the amount charged by independent third parties). Finally, there are no general refund rights. Therefore, the equipment and the installation are considered separate units of accounting in the arrangement.

Regardless of whether the installation is performed, the total arrangement consideration is $200,000. Therefore, consideration in the arrangement should be allocated on a relative fair value basis. In this case, the arrangement consideration of $200,000 should be allocated to the separate units of accounting based on their relative fair values. Thus, allocation of the arrangement consideration would be $192,308 [$200,000 × ($200,000 ÷ [$200,000 + $8,000])] to the equipment and $7,692 [$200,000 × ($8,000 ÷ [$200,000 + $8,000])] to the installation service. Additionally, none of the amount allocable to the equipment is contingent upon performing the installation.

Example 4—Automobiles Sold with Lifetime Maintenance Services

Company A is an established auto dealer. Company A's service center provides all scheduled maintenance services (including oil changes) at no additional charge (other than for parts) for any customer who purchases an automobile from Company A for the period that the customer owns the automobile. The customer may also choose to have the maintenance services performed by others without affecting the vehicle warranty, but most customers utilize Company A's maintenance services unless they move to a distant location. Neither Company A nor any other dealer sells the automobile without the lifetime maintenance services. However, Company A sells maintenance services separately to customers who did not purchase their vehicles from Company A. The automobiles are sold subject to a limited warranty and there are no refund rights in the arrangement. Customers are obligated to Company A for all arrangement consideration upon taking delivery of the automobile. Since lifetime maintenance services are not sold separately by Company A, they are not within the scope of Technical Bulletin 90-1.

Evaluation: The first condition for separation is met for the automobile because, even though the automobile is not sold separately by any vendor, it is considered to have standalone value because the customer could resell the automobile on a standalone basis. The second condition for separation also is met. There is sufficient evidence of the fair value of the maintenance services on a separate component basis (as evidenced by the amount charged on a standalone basis by Company A for maintenance services and data available from which to estimate the volume and types of maintenance services provided during a typical customer's ownership of the vehicle). Finally, there are no refund rights (general or otherwise) in the arrangement. Therefore, the automobile and the maintenance services should be considered separate units of accounting in the arrangement.

Consideration in the arrangement should be allocated using the residual method. The fair value of the maintenance services should be determined as described in the above paragraph. The remaining arrangement consideration should be allocated to the automobile. Additionally, none of the amount allocable to the automobile is contingent upon providing the maintenance services.

Example 5—Sale of Home Appliances with Installation and Maintenance Services

Company S is an experienced home appliance dealer. Company S also offers a number of services together with the home appliances that it sells. Assume that Company S regularly sells Appliance W on a standalone basis. Company S also sells installation services and maintenance services for Appliance W. However, Company S does not offer installation or maintenance services to customers who buy Appliance W from other vendors. Pricing for Appliance W is as follows:

•	Appliance W only	$ 800
•	Appliance W with installation service	$ 850
•	Appliance W with maintenance services	$ 975
•	Appliance W with installation and maintenance services	$1,000

Note also that the incremental amount charged by Company S for installation of $50 approximates the amount charged by independent third parties.

Appliance W is sold subject to a general right of return. If a customer purchases Appliance W with installation and/or maintenance services, in the event that Company S does not complete the services satisfactorily, the customer is only entitled to a refund of the portion of the fee that exceeds $800.

Assume that a customer purchases Appliance W with both installation and maintenance services for $1,000. Based on its experience, Company S believes that it is probable that installation of the equipment will be performed satisfactorily to the customer. Company S is evaluating whether Appliance W and the installation service represent separate units of accounting. (The maintenance services are separately priced at $175 and should be accounted for based on the guidance in Technical Bulletin 90-1.)

Evaluation: The first condition for separation is met for Appliance W because it is sometimes sold separately by Company S. The second condition for separation is also met. There is objective and reliable evidence of the fair value of the installation on a separate component basis (as evidenced by the amount charged by independent third parties). The third condition for separation is met because, even though a general right of return exists, performance of the appliance installation is probable and within the control of Company S. Therefore, Appliance W and installation should be accounted for as separate units of accounting.

Company S would allocate $175 of the arrangement consideration to the maintenance services based on the guidance in Technical Bulletin 90-1. Without considering whether any of the amount otherwise allocable to Appliance W is contingent upon the performance of the installation, Company S would allocate the remainder of the arrangement consideration ($825) to Appliance W and the installation service in proportion to their fair values. The fair value of Appliance W is its price when sold separately ($800), and the fair value of the installation service is the amount charged by independent third parties, which approximates $50. Therefore, the amounts otherwise allocable to Appliance W and to the installation services are $776 [$825 × ($800 ÷ [$800 + $50])] and $49 [$825 × ($50 ÷ [$800 + $50])], respectively. Since the customer is entitled only to a refund of the portion of the fee that exceeds $800 if the installation is not performed, no portion of the amount allocable to Appliance W is contingent upon that installation.

Example 6—Biotech License, Research and Development, and Contract Manufacturing Agreement

Biotech Company (Biotech) enters into an agreement with Pharmaceutical Company (Pharma). The agreement includes (a) Biotech licensing certain rights to Pharma, (b) Biotech providing research and development services to Pharma, and (c) Biotech contract manufacturing product for Pharma. Additional details on each of those aspects of the agreement follow.

License: Biotech licenses certain rights on an exclusive basis to Pharma for a period of 10 years. The license gives Pharma the exclusive right to market, distribute, and manufacture Drug B as developed using Technology A. Biotech retains all ownership rights to Technology A and Drug B. There are no when-and-if-available clauses or other performance obligations associated with the license, except as described below.

Research and development: Biotech agrees to provide research and development services on a best-efforts basis to Pharma. Biotech agrees to devote four full-time equivalents to the research and development activities, and Pharma expects to devote several full-time equivalents (FTEs) to the research and development activities as well. The objective of the research and development services is to develop Drug B using Technology A. The ultimate objective is to receive Food and Drug Administration (FDA) approval on Drug B.

Contract manufacturing: If successfully developed, Biotech agrees to manufacture Drug B for Pharma for a period of five years.

Compensation under the arrangement is as follows:

- Biotech receives $5 million up-front upon signing the agreement.
- Biotech receives $2 million upon meeting each of 4 defined milestones ($8 million in total if all 4 defined milestones are met).
- Biotech receives $250,000 per year for each FTE that performs research and development activities.
- Biotech receives "cost plus 30 percent" for manufacturing Drug B (that is, Biotech will receive compensation for its direct costs plus a 30 percent margin for manufacturing Drug B).

None of these payments, once received, are refundable, even if FDA approval is never received. In addition, while Biotech must perform on a best-efforts basis, it is not obligated to achieve the milestones.

While Biotech has licensed certain rights related to Technology A to other parties, Biotech has not licensed Technology A to others for use in the development of Drug B. Likewise, Biotech has not licensed the marketing, distribution, or manufacturing rights of Drug B to any other party.

Pharma must use Biotech to perform the research and development activities necessary to develop Drug B using Technology A because the know-how and expertise related to Technology A is proprietary to Biotech. In other words, Biotech is the only party capable of performing the level and type of research and development services required by Pharma under the agreement. Biotech has determined that the fees charged for the research and development services (that is, the $250,000 per year for each FTE that performs research and development activities) are competitive with what other third-party vendors charge for similar research and development services (that is, they represent the fair value of those services). In addition, Biotech regularly provides similar research and development services to other customers for comparable fees. The fees earned by Biotech if it reaches the milestones represent performance bonuses that are contingent only on performance of the research and development services (that is, they are unrelated to the contract manufacturing deliverable and are not part of the fair value of the research and development services).

Assuming that the contract manufacturing provided by Biotech could be provided by other contract manufacturers (who would not be dependent on Biotech for critical ingredients), the license agreement gives Pharma the right to manufacture the drug; no proprietary information related to the manufacturing process would preclude other parties from being able to manufacture Drug B. Biotech has determined that cost plus 30 percent is competitive with what other third-party contract manufacturers charge for manufacturing drugs similar to Drug B (that is, it represents the fair value of those services). In addition, Biotech regularly provides similar contract manufacturing services for other customers for comparable fees.

Evaluation: There are three deliverables in this arrangement that should be considered for separation: (1) license, (2) research and development activities, and (3) contract manufacturing. The efforts expended by Biotech to reach each of the four defined milestones are considered part of the research and development activities and are not evaluated on a standalone basis. The fees earned by Biotech if it reaches the milestones represent performance bonuses that are contingent only on performance of the research and development services (that is, they are unrelated to the contract manufacturing deliverable).

The license deliverable does not meet the first criterion for separation. The license deliverable does not have standalone value to Pharma. Because Drug B has not yet been developed, the license is of no value to Pharma without the ensuing research and development activities using Technology A, which is proprietary to Biotech. Likewise, Pharma could not sell the license on a standalone basis to another party (that is, without Biotech agreeing to provide the research and development activities for that other party).

On a combined basis, however, the license and research and development activities have value on a standalone basis. That is, Biotech, in similar arrangements, has sold the license and research and development separately from the manufacturing process. Additionally, Pharma could sell that combined unit of accounting to another party.

The combined unit of accounting (license and research and development activities) also meets the second criterion for separation from the contract manufacturing because Biotech has objective and reliable evidence of the fair value of the contract manufacturing (based on what it and other third parties charge for that type of service). Finally, there are no general rights of return in the arrangement. Therefore, the combined unit of accounting should be considered a separate unit of accounting in the arrangement.

Biotech has not entered into any other agreements in which it has (a) licensed the marketing, distribution, and manufacturing rights to Technology A for use in the development of Drug B and (b) agreed to perform research and development activities to develop Technology A into Drug B. In addition, given the unique nature of Technology A, third-party fair value evidence for the combined unit of accounting also does not exist. As such, Biotech does not have objective and reliable evidence of the fair value of the combined unit of accounting. Based on that analysis, the method of allocating the arrangement consideration would be the residual method because fair value evidence exists for the contract manufacturing, but not the combined unit of accounting. Because the contract manufacturing deliverable is priced at its fair value, none of the other arrangement consideration should be allocated to the contract manufacturing deliverable.

Example 7—Sale of Medical Equipment with Cartridges and Installation

Company M manufactures and sells complex medical equipment to physicians and hospitals for medical scanning purposes. Prior to shipment, each piece of equipment is extensively tested to meet company and FDA specifications. The equipment is shipped fully assembled, but some installation and setup is required.

Installation is a standard process, outlined in the owner's manual, consisting principally of uncrating, calibrating, and testing the equipment. A purchaser of the equipment could complete the process using the information in the owner's manual, although it would probably take significantly longer than it would take Company M's technicians to perform the tasks. While the process is not complex and does not involve proprietary information, other vendors do not provide the service. Historically, most installations are performed by Company M and are completed within 7–24 days of shipment. Installation is included in the overall sales price of the equipment (that is, Company M does not sell the equipment on a noninstalled basis) and has an estimated fair value of $20,000 (based on per diem rates for technician time).

In addition, the customer must pay for cartridges that record images. The retail price of each cartridge is $250. Company M is the only manufacturer of the cartridges but also sells them on a wholesale basis through a wide network of distributors. Each cartridge can handle only a specific number of scans. Once a cartridge is exhausted, a new one must be purchased in order to use the equipment. Company M always sells its equipment with a starter supply of 20 cartridges.

The sales price of the arrangement that consists of the equipment, installation, and 20 cartridges is $400,000. The customer is obligated to pay in full upon delivery of the equipment. The customer is entitled to a refund of $25,000 if Company M does not perform the installation or if the 20 cartridges are not delivered. On March 15, Company M delivers the equipment and on April 5 delivers the 20 cartridges and performs the installation. Company M is evaluating whether delivery of the equipment represents a separate unit of accounting.

Evaluation: The first condition for separation is met for the equipment because, even though Company M has never sold the equipment without the cartridges, a customer could resell the equipment (in a primary or secondary market). The second condition for separation is also met because objective and reliable evidence of fair value exists for the cartridges and the installation based on third-party evidence and Company M's entity-specific evidence of fair value. The third condition for separation is met because there are no general rights of return involved in this arrangement. Therefore, the equipment should be accounted for as a separate unit of accounting.

The residual method should be used to allocate the arrangement consideration. Accordingly, the amount otherwise allocable to the equipment, cartridges, and installation would be as follows: $375,000 to the equipment ($400,000 – [$250 × 20] – $20,000), $5,000 to the cartridges ($250 × 20), and $20,000 to the installation. Additionally, no portion of the amount allocable to the equipment is contingent upon the delivery of the cartridges or performance of the installation. That is, if the cartridges are not delivered and the installation is not performed, Company M would be entitled to $375,000.

Example 8—Sale of Computer System

Company B sells computer systems. On April 20, a customer purchases a computer system from Company B for $1,000. The system consists of a CPU, a monitor, and a keyboard. On April 30, Company B delivers the CPU to the customer without the monitor or keyboard. Each of the items can be purchased separately at a cost of $700 for the CPU, $300 for the monitor, and $100 for the keyboard. The CPU could function with monitors or keyboards manufactured by others, who have them readily available. The customer is entitled to a refund equal to the separate price of any item composing the system that is not delivered. The arrangement does not include any general rights of return. Company B is evaluating whether delivery of the CPU represents a separate unit of accounting.

Evaluation: The first condition for separation is met for the CPU, as it is sold separately by Company B. The second condition for separation is met because the fair values of the undelivered items (keyboard and monitor) are objectively and reliably determined based on the price of that equipment when sold separately by Company B. The third condition for separation is met because there are no general rights of return. Therefore, the CPU should be accounted for as a separate unit of accounting.

Without considering whether any portion of the amount allocable to the CPU is contingent upon delivery of the other items, Company B would allocate the arrangement consideration on a relative fair value basis. Therefore, the portion of the arrangement fee otherwise allocable to the CPU is $636.36 ($1,000 × [$700 ÷ $1,100]), of which $36.36 ($636.36 – [$1,000 – $400]) is subject to refund if the monitor and keyboard are not delivered. Therefore, the amount allocable to the CPU is limited to $600, which is the amount that is not contingent upon delivery of the monitor and keyboard.

Example 9—Sale of 12 Bolts of Fabric

Company D sells fabric for use in manufacturing clothing. Customers may purchase fabric from Company D in individual 50-yard bolts or in bulk lots consisting of multiple bolts. One of Company D's customers (Customer A) is a manufacturer of band uniforms that prefers to purchase the fabric in bulk because it needs the fabric to have a high level of consistency in color and quality. Customer A enters into an arrangement with Company D to purchase a 12-bolt bulk lot of fabric that is to be delivered by Company D in 3 4-bolt installments over a period of 3 months. At Customer A's request, Company D provides a customer satisfaction guarantee that it will refund double the price (up to a maximum of the total arrangement fee) for each bolt of fabric that is not delivered or not delivered from the same dye lot as the initial installment. That is, the double-money-back guarantee provides that the customer, in addition to having no obligation for bolts of fabric not delivered or not delivered from the appropriate dye lot, will receive a refund for (or will not be obligated to pay for) an equal number of bolts. There are no general rights of return included in the arrangement. The price for an individual 50-yard bolt of fabric is $160, and the price for a 12-bolt bulk lot is $1,824.

In determining the units of accounting under the arrangement, Company D considered the following scenario:

> Company D sold the 12-bolt bulk lot of fabric to Customer A on November 1, 20X2. Company D will deliver the first of three four-bolt installments of fabric on November 15 and will deliver the remaining installments on December 15, 20X2, and January 15, 20X3. Customer A is obligated to Company D for the full price of the fabric on November 15, 20X2, subject to the money-back guarantee. Company D has sufficient production capacity and inventory to deliver all of the fabric in accordance with the installment provisions of the arrangement and, therefore, believes that it will do so. In addition, Company D has entered

into similar arrangements with many other customers in the past and has rarely failed to deliver fabric from the appropriate die lot under its bulk-sale arrangements.

Evaluation: The first condition for separation is met for the delivered fabric because Company D also sells bolts of fabric individually. The second condition for separation is also met because objective and reliable evidence of fair value exists based on Company D's vendor-specific evidence of fair value. Arrangement consideration would be allocated evenly among the 12 bolts of fabric because each has an identical fair value (based on Company D's vendor-specific evidence of fair value). The third condition for separation is met because there are no general rights of return in the arrangement. Therefore, the delivered fabric should be accounted for as a separate unit of accounting.

However, in allocating the arrangement consideration, no amount is allocable to the initial delivered fabric because the arrangement provides the customer with a double-money-back guarantee for each bolt of fabric not delivered from the same die lot as the initial installment. However, upon delivery of the second four-bolt installment (assuming that installment is delivered from the same die lot as the initial installment), the amount allocable to that installment would be the amount related to four bolts of fabric. That is, if the third installment was not delivered or was not delivered from the same die lot as the initial installment, Company D would be entitled only to the price charged for four bolts of fabric.

Example 10—Painting Contract

PainterCo is a contractor that provides painting services for commercial and private residences. PainterCo contracts with a customer to paint the customer's house for $3,000. The price is inclusive of all paint, which is obtained by PainterCo at a cost of $800. The customer is given the right to purchase paint separately if so desired (although the customer did not opt to do so in this example). The paint would have cost the customer $900 if purchased from a hardware store. The painting service would have cost $2,150 if purchased without the paint.

All paint necessary to complete the project is delivered to the customer's house prior to the beginning of the work. The customer has a general right of return with respect to any unopened can of paint. Further, the customer may receive a full refund of the sales price for all of the paint (whether or not the cans were opened) if PainterCo does not paint the house. PainterCo has always completed the painting service in accordance with contract terms and, therefore, believes that performance of the painting service in this arrangement is probable. PainterCo does not sell paint without providing the painting service.

Evaluation: The first condition for separation is met because the paint is sold separately by other vendors. The second condition for separation is also met for the painting service because objective and reliable evidence of fair value exists as PainterCo sells the painting service separately. The third condition for separation is met because, even though a general right of return exists, performance of the painting service is probable and within the control of PainterCo. Therefore, the paint and the painting service are considered separate units of accounting.

However, in allocating the arrangement consideration, no amount would be allocated to the paint because, in the event that PainterCo does not perform the painting service, the customer may return all of the paint for a full refund.

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

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

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. 122, Accounting for Mortgage Servicing Rights

FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

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 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, *Allowance Adjustments*

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, a qualifying SPE that becomes tainted will generally result in the "re-purchase" by the transferor of *all* assets transferred to and held by the SPE.

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 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

[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.

[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.

right to purchase a specific transferred asset. Under the requirements of paragraph 55 of Statement 140, 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 of Statement 140 because the transferor's contingent right (for example, a "ROAP" or other contingent call option on the transferred financial assets) becomes exercisable, and, in particular, how much of any gain or loss[3] should the transferor recognize when paragraph 55 of Statement 140 is applied.

Issue 2—How assets of an SPE that was formerly considered qualifying should be accounted for when the entire SPE becomes non-qualifying under the provisions of paragraph 55 of Statement 140, including whether the transferor should recognize a gain or loss when paragraph 55 of Statement 140 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 of Statement 140. (Formerly Issue 2.)

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

Prior EITF Discussion

5. At the September 11–12, 2002 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 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.

[3] Some potentially recognizable gain or loss arises from the difference between the strike price of the option (ROAP) and the fair value of the assets that had been previously transferred to the qualifying SPE. Additional potentially recognizable gain may arise if unrealized appreciation in the transferor's retained beneficial interest has been recorded in OCI.

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.

Current EITF Discussion

7. At the November 21, 2002 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. A gain or loss may be recognized only with respect to the "re-purchased" third-party beneficial interests (the portion of the transferred assets that were sold) and only if a ROAP or similar contingent right held by the transferor that is not accounted for as a derivative under Statement 133 is not at-the-money, resulting in the fair value of those beneficial interests being greater or less than related obligations to the transferee. Beneficial interests should be evaluated periodically for possible impairment, including at the time paragraph 55 is applied.

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.

Status

9. Further discussion is expected at a future meeting.

Issue No. 02-12

Title: Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

Dates Discussed: June 19–20, 2002; September 11–12, 2002; November 21, 2002

References: FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

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

FASB Technical Bulletin No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*

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*

Proposed FASB Interpretation, *Consolidation of Certain Special-Purpose Entities*

Introduction

1. Guidance provided by Statement 140 for distinguishing between transfers of financial assets that are sales and those that are secured borrowings focuses on whether control over the transferred assets has been surrendered by the transferor and obtained by the transferee. A transferor has surrendered control over transferred financial assets if the three conditions in paragraph 9 of Statement 140 are met. Paragraph 9(b) of Statement 140 (the second condition) states:

> Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29–34).

2. In a securitization, financial assets are transferred to a securitization vehicle or special-purpose entity (SPE) that issues beneficial interests in those assets to investors and, perhaps, the transferor. The beneficial interests provide the holders with the right to receive specified cash inflows from the assets held by the SPE. In most securitizations, the SPE is constrained from pledging or exchanging the transferred financial assets. However, the holders of the beneficial interests usually are free to exchange or pledge their interests. Thus, for the transfer to be accounted for as a sale, the SPE must be a qualifying SPE (as defined in Statement 140) to meet all of the conditions in paragraph 9 of Statement 140. If it is a qualifying SPE, then the transferor does not consolidate the SPE. If certain other criteria are met, the assets are

derecognized, and no liability is recognized, in the consolidated financial statements of the transferor and its subsidiaries.

3. Statement 140 specifies restrictive conditions that must be met for an SPE to be considered qualifying. To be considered a qualifying SPE, paragraph 35 of Statement 140 requires that:

a. It is demonstrably distinct from the transferor (paragraph 36).
b. Its permitted activities be (1) significantly limited, (2) entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds, and (3) significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 37 and 38).
c. It may hold only: [specified assets as described in paragraph 35(c)(1)–(6)].
d. … it can sell or otherwise dispose of noncash financial assets … only in automatic response to [certain specified] conditions….

4. While Statement 140 is very specific about the activities of a qualifying SPE with regard to the assets it holds and the derivatives it enters into, that Statement contains little discussion about the issuance of beneficial interests. Statement 140 does not specify whether either (a) the conditions for a qualifying SPE require that the terms of beneficial interests to be issued be specified at inception of the entity or (b) the qualifying SPE (or its designee or agent) may establish the terms of replacement beneficial interests. Issues arise in two common securitization situations that are described below.

Example 1—Initial Issuances after Inception
In typical revolving-period securitizations (like credit-card securitizations), the transferor continuously transfers receivables into the securitization vehicle. The transferor receives either (a) cash proceeds or (b) an increased beneficial interest in the securitization vehicle. When the transferor receives only increased beneficial interests in the securitization vehicle, a sale is not recorded for accounting purposes (discussed more completely in paragraph 79 of Statement 140). It is common for a transferor to "build up" this retained interest for a period of time. At some point, often selected by the SPE or its designee or agent (which may be the transferor or its affiliate), the qualifying SPE will issue beneficial interests in those receivables to third parties, resulting in the recognition of a sale by the transferor. The beneficial interests issued have longer terms than the short-term assets in the securitization vehicle.

Example 2—Refinancings
In some securitizations, longer-term assets are financed with short-term beneficial interests. For example, an SPE initially issues beneficial interests in the form of commercial paper with an average term of 90 days. The securitization vehicle holds receivables due in five years, which is also the intended life of the vehicle. Thus, when the 90-day commercial paper becomes due, the SPE must issue replacement beneficial interests (expressed another way, it must refinance) often on terms selected by the SPE or

> its designee or agent. If for any reason the SPE is unable to issue replacement beneficial interests to investors, commonly the existing beneficial interests are to be repaid by a loan to be drawn down under a prearranged backup line of credit. Such "liquidity backup lines" are sometimes provided by the transferor or its affiliate; in other cases, the liquidity backup lines are provided by third parties. The transferor typically recognizes a sale of the receivables at the time of the initial transfer and issuance of beneficial interests.

Issues

5. The issues are:

Issue 1(a)—The extent to which a qualifying SPE (or its affiliate or agent) is permitted to determine the terms of beneficial interests issued after the inception of the qualifying SPE (i) prior to the derecognition by the transferor of the assets that the beneficial interests represent (Example 1) or (ii) after derecognition by the transferor of the assets that the beneficial interests represent (Example 2)

Issue 1(b)—If an existing SPE (or its designee or agent) determines the terms of new beneficial interests, whether the conditions requiring that a qualifying SPE's activities be "significantly limited" and "entirely specified" have a different effect on a structure that contains long-term assets and issues short-term beneficial interests (LT/ST structure, Example 2) than on a structure that contains short-term assets and issues long-term beneficial interests (ST/LT structure, Example 1)

Issue 2—If a qualifying SPE (or its designee or agent) is permitted to determine the terms of newly issued beneficial interests as described in Issue 1, whether it would be permissible for the transferor to have the ability to direct the qualifying SPE to prepay previously issued beneficial interests with proceeds of newly issued beneficial interests.

Prior EITF Discussion

6. At the June 19–20, 2002 meeting, the Task Force discussed the meaning of the phrases *significantly limited* and *entirely specified* in paragraph 35(b) of Statement 140 in relation to issuances of beneficial interests after the inception of a qualifying SPE. The Task Force discussed whether a qualifying SPE can have the power to exercise judgment in determining the terms of beneficial interests within a range specified in the legal documents that established the SPE or that created its earlier beneficial interests and, if so, whether the range should be based on time to maturity, on markets (types of instruments), or on both.

7. A Task Force member noted that an additional issue relates to transfers to qualifying SPEs under a master trust arrangement. The Task Force did not reach agreement on that additional issue and did not discuss Issue 2.

8. The Task Force reached a tentative conclusion on one aspect of Issue 1 that a limitation to beneficial interests with terms of 270 days or less would establish a range that could be considered significantly limited. The Task Force discussed other ranges that might be considered significantly limited and other ways of providing guidance to interpret *significantly*

limited and *entirely specified* but was not asked to reach a consensus The Task Force requested that the FASB staff conduct further research on this Issue to better understand the characteristics of market instruments.

9. At the September 11–12, 2002 meeting, the Task Force discussed Issues 1(a) and 1(b) and considered four approaches, including an expanded version of the approach discussed at the June 19–20, 2002 meeting. Those approaches attempt to clarify the meaning of *significantly limited* and *entirely specified* in the context of the ability of a qualifying SPE to issue beneficial interests after the inception of a qualifying SPE. The Task Force was not asked to reach a consensus. However, the Task Force expressed an initial preference for an approach that focuses on whether the maturities of the beneficial interests are *well supported* by the underlying assets of the qualifying SPE. The Task Force asked the FASB staff to provide further clarification with respect to the concept of *well supported* and to consider the types of guarantees or liquidity arrangements that may be provided by the transferor, its affiliates, and its agents, and whether those arrangements affect the determination of whether the beneficial interests are *well supported*.

Current EITF Discussion

10. At the November 21, 2002 meeting, the Task Force discussed Issues 1(a) and 1(b) but was not asked to reach a consensus on either Issue. The Task Force asked the staff to further develop and clarify both the approach focusing on whether maturities of beneficial interests are *well supported* and the approach focusing on restrictions on the maturities and other aspects of beneficial interests that replace other beneficial interests. Issue 2 is to be included within the Task Force discussions of Issue 1(b).

Status

11. Further discussion is expected at a future meeting.

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

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 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 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

Proposed FASB Interpretation, *Consolidation of Certain Special-Purpose Entities*, dated June 28, 2002

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

APB Opinion No. 14, *Accounting for Convertible Debt and Debt issued with Stock Purchase Warrants*

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)

[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]. . . ."

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 holding an investment in voting common stock of the investee. Some people believe that existing authoritative literature already addresses an investors' accounting for a number of those kinds of 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 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.

Current EITF Discussion

7. At the November 21, 2002 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

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

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

method investments and investments subject to Statement 115 and that that issue be addressed by the Task Force as a separate EITF Issue.

Status

9. Further discussion is expected at a future meeting.

Issue No. 02-16

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

Dates Discussed: September 11–12, 2002; November 21, 2002

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

FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*

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

FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

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

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

AICPA Audit and Accounting Guide, *Agricultural Producers and Agricultural Cooperatives*

International Accounting Standard 20, *Accounting for Government Grants and Disclosure of Government Assistance*

Introduction

1. EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)," addresses the accounting by a **vendor**[1] for consideration given to a **customer**, including both a **reseller** of the vendor's products and an entity that purchases the vendor's products from a reseller. That Issue provided accounting guidance on how a vendor should characterize consideration given to a customer and when to recognize and how to measure that consideration in its income statement.

2. Questions have arisen regarding how a reseller of a vendor's products should account for **cash consideration** (as that term is defined in Issue 01-9) received from a vendor.

Issues

3. The issues are:

Issue 1—The circumstances under which cash consideration received from a vendor by a reseller should be considered (a) an adjustment of the prices of the vendor's products or services and, therefore, characterized as a reduction of cost of sales when recognized in the reseller's income statement, (b) an adjustment to a cost incurred by the reseller and, therefore, characterized as a reduction of that cost when recognized in the reseller's income statement, or (c) a payment for

[1] Terms defined in Exhibit 02-16B, the glossary, are set forth in **boldface type** the first time they appear.

assets or services delivered to the vendor and, therefore, characterized as revenue when recognized in the reseller's income statement.

Issue 2—If a vendor offers a customer a rebate or refund of a specified amount of cash consideration that is payable only if the customer completes a specified cumulative level of purchases or remains a customer for a specified time period, when the customer should recognize the rebate and how the customer should measure the amount of the offer.

Issue 3—Under what circumstances up-front nonrefundable cash consideration given by a vendor to a customer should be recognized immediately in the customer's income statement rather than as a liability.

Issue 4—How to measure and when to recognize the reduction of a liability incurred upon receipt of up-front nonrefundable cash consideration in the customer's income statement.

Prior EITF Discussion

4. At the September 11–12, 2002 meeting, the Task Force discussed Issue 1 but was not asked to reach a consensus. The Task Force asked the FASB staff to expand the scope of this Issue to (a) include resellers that sell goods or services to a vendor (that is, resellers and vendors that sell goods or services to each other), (b) include end-users that receive cash consideration from a vendor, and (c) provide guidance on the recognition and measurement of cash consideration (including up-front nonrefundable cash consideration) received from a vendor.

5. The SEC Observer commented that, until further guidance is issued, resellers that provide goods or services to a vendor from which they also purchase goods or services should consider whether certain transactions between the two parties (for example, a reseller providing goods or services to a vendor with a contemporaneous agreement to purchase an equal amount of that vendor's goods or services) are subject to the guidance contained in paragraph 21 of Opinion 29.

6. The Task Force did not discuss Issue 2.

Current EITF Discussion

7. At the November 21, 2002 meeting, the Task Force reached a consensus on Issue 1 that cash consideration received by a customer from a vendor is presumed to be a reduction of the prices of the vendor's products or services and should, therefore, be characterized as a reduction of cost of sales when recognized in the customer's income statement. However, that presumption is overcome when the consideration is either (a) a payment for assets or services delivered to the vendor, in which case the cash consideration should be characterized as revenue (or other income, as appropriate) when recognized in the customer's income statement, or (b) a reimbursement of costs incurred by the customer to sell the vendor's products, in which case the cash consideration should be characterized as a reduction of that cost when recognized in the customer's income statement.

8. The Task Force reached a consensus that cash consideration represents a payment for assets or services delivered to the vendor, and should be characterized as revenue (or other income, as appropriate) when recognized in the customer's income statement if the vendor receives, or will

receive, an identifiable benefit (goods or services) in exchange for the consideration. In order to meet that condition the identified benefit must be sufficiently separable from the customer's purchase of the vendor's products such that the *customer* would have entered into an exchange transaction with a party other than the vendor in order to *provide* that benefit, and the customer can reasonably estimate the fair value of the benefit provided. If the amount of cash consideration paid by the vendor exceeds the estimated fair value of the benefit received, that excess amount should be characterized as a reduction of cost of sales when recognized in the customer's income statement.

9. The Task Force reached a consensus that cash consideration represents a reimbursement of costs incurred by the customer to sell the vendor's products and should be characterized as a reduction of that cost when recognized in the customer's income statement if the cash consideration represents a reimbursement of a specific, incremental, identifiable cost incurred by the customer in selling the vendor's products or services. If the amount of cash consideration paid by the vendor exceeds the cost being reimbursed, that excess amount should be characterized in the customer's income statement as a reduction of cost of sales when recognized in the customer's income statement.

10. The Task Force reached a consensus on Issue 2 that a rebate or refund of a specified amount of cash consideration that is payable pursuant to a binding arrangement only if the customer completes a specified cumulative level of purchases or remains a customer for a specified time period should be recognized as a reduction of the cost of sales based on a systematic and rational allocation of the cash consideration offered to each of the underlying transactions that results in progress by the customer toward earning the rebate or refund provided the amounts are probable and reasonably estimable. If the rebate or refund is not probable and reasonably estimable, it should be recognized as the milestones are achieved.

11. The Task Force observed that the ability to make a reasonable estimate of the amount of future cash rebates or refunds depends on many factors and circumstances that will vary from case to case. However, the Task Force reached a consensus that the following factors may impair a customer's ability to determine whether the rebate or refund is probable and reasonably estimable:

a. The rebate or refund relates to purchases that will occur over a relatively long period.
b. There is an absence of historical experience with similar products or the inability to apply such experience because of changing circumstances.
c. Significant adjustments to expected cash rebates or refunds have been necessary in the past.
d. The product is susceptible to significant external factors (for example, technological obsolescence or changes in demand).

12. The Task Force reached a consensus that changes in the estimated amount of cash rebates or refunds and retroactive changes by a vendor to a previous offer (an increase or a decrease in the rebate amount that is applied retroactively) are changes in estimate that should be recognized using a cumulative catch-up adjustment. That is, the customer would adjust the cumulative balance of its rebate recognized to the revised cumulative estimate immediately. The Task Force observed that entities should consider whether any portion of the cumulative-effect adjustment

impacts, for example, inventory, in which case only a portion of that adjustment would be reflected in the income statement.

13. The Task Force agreed to discontinue consideration of Issues 3 and 4 regarding whether up-front nonrefundable cash consideration given by a vendor to a customer results in a liability or should be recognized immediately in the customer's income statement due to the broad, general nature of related questions.

14. The examples in Exhibit 02-16A illustrate the consensuses reached in this Issue.

Transition

15. Subsequent to the November 21, 2002 meeting, the Task Force modified the transition guidance agreed to at that meeting. At that meeting, the Task Force agreed that the consensus on Issue 1 should be applied to fiscal periods beginning after December 15, 2002, with early application permitted. Additionally, the Task Force indicated that income statements for prior periods presented should be reclassified to comply with the consensus on Issue 1, unless such reclassification is impracticable. However, subsequent to that meeting, Task Force members acknowledged that the recasting of prior-period financial statements for comparative purposes might impact certain balance sheet and income statement account balances such that the net income of prior periods would be changed. Accordingly, the transition guidance in the following paragraph is provided to consider such circumstances.

16. The consensus on Issue 1 should be applied to fiscal periods beginning after December 15, 2002. Upon application of the consensus on Issue 1, income statements for prior periods presented should be reclassified to comply with that consensus, provided that the recasting of prior-period financial statements does not result in a change to net income of those prior periods. If it is impracticable to reclassify prior-period financial statements, disclosure should be made of the reasons therefore and the effect of the reclassification on the current period. Early application of the consensus on Issue 1 is permitted only if a change to previously reported net income would not occur as a result of changes to prior period financial statements. At its January 23, 2003 meeting, the Task Force intends to further discuss transition for entities in which previously reported net income would be changed as a result of recasting prior-period financial statements for comparative purposes.

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

Status

18. Further discussion is expected at a future meeting.

Exhibit 02-16A

EXAMPLES OF THE APPLICATION OF THE CONSENSUS

Example 1

Vendor manufactures toys that are sold by Retailer. Vendor offers a **cooperative advertising** arrangement through which Retailer receives an allowance for qualifying advertising costs of up to 2 percent of the total purchases from Vendor if certain qualitative criteria are met. Retailer must maintain documentation of advertising performed and related costs.

Evaluation: The cash consideration received for cooperative advertising, to the extent that it represents a reimbursement of specific, incremental, identifiable costs incurred by the customer to sell Vendor's products, should be characterized as a reduction of those costs when recognized in the customer's income statement, provided that the cash consideration received does not exceed such costs incurred. If the amount of cash consideration paid by Vendor exceeds the costs being reimbursed, that excess amount should be characterized as a reduction of cost of sales when recognized in Retailer's income statement.

Example 2

Retailer enters into an agreement with Vendor to perform a significant amount of market research for Vendor related to the launch of a new product. Vendor believes that it is paying for the expertise and knowledge available from Retailer. Retailer believes Vendor is electing to purchase its knowledge of the market rather than internally developing such knowledge. Retailer would offer such services to a nonvendor.

Evaluation: The cash consideration received is in return for Retailer providing goods or services that provide an identifiable benefit to Vendor that is sufficiently separable from Retailer's purchase of Vendor's goods. Since Retailer offers those research services to a nonvendor and the fair value of the research services is determinable, the cash consideration received from the vendor represents revenue (or other income, as appropriate) and should be characterized as such when recognized in Retailer's income statement, provided that the cash consideration received does not exceed the estimated fair value of the benefit received by Vendor. If the amount of cash consideration paid by Vendor exceeds the estimated fair value of related benefits received, that excess amount should be characterized as a reduction of cost of sales when recognized in Retailer's income statement.

Example 3

On January 1, 20X1, in a binding arrangement, Vendor offers a cash refund of $1,000 to Customer if during the calendar year 2001, Customer purchases 1,000 units. Customer, on average, purchases 1,700 units each year.

Evaluation: Since Customer is entitled to the refund offered by Vendor based on the purchase of 1,000 units of inventory, Customer should accrue the refund offer over the purchase of the 1,000 units, provided that it is probable and reasonably estimable that Customer will purchase 1,000 units during 20X1.

Exhibit 02-16B

GLOSSARY

This exhibit contains definitions of certain terms used in this Issue.

Cash consideration
For purposes of this Issue, cash consideration includes cash payments and "credits" that the customer can apply against trade amounts owed to the vendor. In addition, under the consensus on Issue 2 of 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," consideration in the form of equity instruments is recognized "in the same period(s) and in the same manner (that is, capitalize versus expense) as if the enterprise had paid cash for the goods or services or used cash rebates as a sales discount instead of paying with or using the equity instruments." Accordingly, for purposes of this Issue, guidance with respect to cash consideration is applicable to consideration that consists of equity instruments (regardless of whether a measurement date has been reached). For purposes of this Issue, cash consideration may be referred to by terms such as sales incentives, discounts, coupons, rebates, price reductions, and so forth.

Cooperative advertising
A vendor agrees to reimburse a customer for a portion of the advertising costs incurred by the customer. Cooperative advertising programs generally provide that a vendor will participate in the cost of a customer's advertising. The amount reimbursed to the customer typically is limited to a specified percentage of that customer's purchases from the vendor. The program may or may not require the customer to provide documentation of the actual costs incurred to advertise the vendor's products.

Customer
A reseller or a consumer (either an individual or a business that purchases a vendor's products or services for end use rather than for resale). Customer should be defined consistent with paragraph 39 of Statement 131, which states that "a group of entities known to a reporting enterprise to be under common control shall be considered as a single customer, and the federal government, a state government, a local government (for example, a county or municipality), or a foreign government each shall be considered as a single customer." For purposes of this Issue, customer includes any purchaser of the vendor's products at any point along the distribution chain, regardless of whether the purchaser acquires the vendor's products directly or indirectly (for example, from a distributor) from the vendor. For example, a vendor may sell its products to a distributor who in turn resells the products to a retailer. The retailer in that example is a customer of the vendor as that term is used in this Issue.

Reseller
Any entity that purchases another vendor's products for resale, regardless of whether that entity is a distributor or wholesaler, retailer, or other type of reseller.

Vendor
For purposes of this Issue, the term vendor is used to represent a service provider or product seller, such as a manufacturer, distributor, or reseller.

Issue No. 02-18

Title: Accounting for Subsequent Investments in an Investee after Suspension of Equity Method Loss Recognition

Dates Discussed: October 25, 2002; November 21, 2002

References: 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 Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*

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

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

AICPA Accounting Interpretation 2, "Goodwill in a Step Acquisition," of APB Opinion No. 17, *Intangible Assets*

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

AICPA Technical Q&A 2220.14, "Equity Method—Effect of Unrecorded Equity in Losses on Additional Investment"

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

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

Introduction

1. Paragraph 19 of Opinion 18 provides specific guidance on applying the equity method of accounting including the specific procedures relating to the losses of an investee. The investor's accounting for past and continuing operating losses of the investee follows Opinion 18, paragraph 19(i), which states:

> An investor's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by the equity method plus advances made by the investor. The investor ordinarily should discontinue applying the equity method when the investment (and net advances) is reduced to zero and should not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee. If the investee subsequently reports net income, the investor should resume applying the equity method only after its share of that net income equals

> the share of net losses not recognized during the period the equity method was suspended. [Footnote reference omitted.]

2. *EITF Abstracts*, Topic No. D-68, "Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of an Investee," provides that Opinion 18 requires an investor who owns common (or other voting) stock and also (a) owns debt securities (including mandatorily redeemable preferred stock), (b) owns preferred stock, or (c) has extended loans to the investee, to continue to report losses.

3. As a result of Topic D-68, a question arose as to the interaction between the application of Opinion 18 on the recording of equity method losses (when the carrying amount of the common stock has been reduced to zero) and applicable literature relating to other investments in the investee (either Statement 114 or Statement 115). EITF Issue No. 98-13, "Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee," addresses that question and indicates that in situations in which (a) an investor is not required to advance additional funds to the investee and (b) previous losses have reduced the common stock investment to zero, the investor should continue to report its share of equity method losses in its statement of operations to the extent of and as an adjustment to the adjusted basis of the other investments in the investee.

4. A subsequent question arose as to the proper accounting for subsequent investments in an investee after suspension of equity method loss recognition (assuming the guidance in paragraph 19(i) of Opinion 18 and Issue 98-13 have been appropriately applied).

5. *EITF Abstracts*, Topic No. D-84, "Accounting for Subsequent Investments in an Investee After Suspension of Equity Method Loss Recognition When an Investor Increases Its Ownership Interest from Significant Influence to Control through a Market Purchase of Voting Securities," provides the SEC staff's position on subsequent investments in an investee after suspension of equity method loss recognition when an investor increases its ownership interest from significant influence to control through a market purchase of voting securities. Topic D-84 states:

> ...in the circumstances in which an investor increases its ownership interest from one of significant influence to one of control through the purchase of additional voting securities in the market, and where no commitment or obligation to provide financial support existed prior to obtaining control, the acquisition should follow step acquisition accounting. Recognition of a "loss on purchase" or a restatement of prior-period financial statements is not appropriate.

6. Topic D-84 addresses when the additional investment in the investee results in an increase in ownership from significant influence to control; however, it does not specifically address subsequent investments in an investee that do *not* increase the ownership interest from one of significant influence to one of control (for example, from 25 percent to 45 percent).

7. Currently, the only guidance (although nonauthoritative) specifically addressing subsequent investments in an investee that do not increase the ownership interest from one of significant influence to one of control is included in TPA 2220.14. TPA 2220.14 states the following:

> Inquiry – Company A purchased 40 percent of Company B for $100,000. Company A did not guarantee the debt of Company B. Subsequent to the investment by A, B incurred large operating losses and A ceased to record equity in B's losses after its investment in B was reduced to zero. A few years later, A purchased an additional 5 percent interest in B. Should Company A offset the amount of this additional investment by the unrecorded equity in losses of Company B?
>
> Reply – No. Company A's additional investment would not be offset by the unrecorded equity in Company B's losses because A's unrecorded equity in those losses is not attributable to the block of shares in comprising the additional 5 percent interest.

Issue

8. Assuming an investor has appropriately suspended equity method loss recognition in accordance with paragraph 19(i) of Opinion 18 and Issue 98-13, whether an investor should offset the amount of an additional investment by previously suspended losses when accounting for a subsequent investment in an investee that does not result in the ownership interest increasing from one of significant influence to one of control.

Prior EITF Discussion

9. At the October 25, 2002 meeting, the Task Force discussed this Issue but did not reach a consensus. The Task Force asked the FASB staff to clarify that any consensus on this Issue would apply not only to additional investments in common (or other voting) stock but also to other investments including, but not limited to, preferred stock, debt securities, and loans to the investee.

10. The Task Force also observed that determining the appropriate accounting for an additional investment should depend on whether the additional investment is, in substance, the funding of prior losses. That determination may depend on the facts and circumstances of the investment, such as whether the additional investment is acquired from a third party or directly from the investee and whether the additional investment results in an increase in ownership interest. The Task Force asked the FASB staff to develop indicators that should be considered in determining whether, in substance, the additional investment is funding previous losses of the investee.

Current EITF Discussion

11. At the November 21, 2002 meeting, the Task Force discussed certain indicators that should be considered in determining whether, in substance, the additional investment in an equity-method investee is funding previously suspended losses, but it did not reach a consensus. The Task Force asked the FASB staff to further develop and clarify those indicators.

Status

12. Further discussion is expected at a future meeting.

FASB EMERGING ISSUES TASK FORCE
Inventory of Open Issues
as of November 21, 2002

Issue Number	Issue	FASB Staff Assigned
98-4	Accounting by a Joint Venture for Businesses Received at Its Formation	TBD
00-18	Accounting Recognition for Certain Transactions involving Equity Instruments Granted to Other Than Employees	Lynn/ 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 Is 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
02-2	When Separate Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes	Martin/ Wilkins
02-9	Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold	Lusniak/ Bullen
02-12	Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*	Lusniak/ Bullen
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
02-18	Accounting for Subsequent Investments in an Investee after Suspension of Equity Method Loss Recognition	Munro/ Parrott

Issue **Number**	**Issue**	FASB Staff **Assigned**
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	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 November 21, 2002

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 Is a Lease." Prior to its rescission, Issue 98-10 stated that when the trading criteria in the consensus are met, energy contracts, including "energy-related contracts" such as tolling, transportation, and storage contracts, should be accounted for at fair value. However, Issue 98-10 also observed that some energy-related contracts may be leases and subject to the accounting specified by FASB Statement No. 13, *Accounting for Leases*, and other related literature. Upon further consideration, the issue of whether an arrangement represents a lease is not unique to energy-related contracts. As such, the issue is more broadly stated as how to determine whether an arrangement is a lease 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 02-2, "When Separate Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes." Companies may, for various reasons, contemporaneously enter into multiple contracts that individually meet the definition of a financial instrument in paragraph 540 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. 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. The issue is how to determine when separate contracts that meet the definition of financial instruments should be combined for accounting purposes.

Issue 02-9, "Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold." Paragraph 55 of Statement 140 requires a transferor to recognize in its financial statements assets previously accounted for appropriately as having been sold when one or more of the conditions in paragraph 9 (regarding control of the assets) are no longer met. The transferor recognizes those assets together with liabilities to the former transferee(s) or BIHs in those assets and initially measures the assets and liabilities at fair value on the date of the change, as if the transferor purchased them on that date. The issue is how to apply the accounting requirements of paragraph 55 with respect to beneficial interests held by the transferor and loans that do not meet the definition of *security*, including whether the transferor should recognize a gain or loss when paragraph 55 is applied.

Issue 02-12, "Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*." Paragraph 35 of Statement 140 specifies certain restrictive conditions that must be met in order for an SPE to be considered qualifying. Those conditions include a requirement that the SPE's permitted activities (1) are significantly limited, (2) were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds, and (3) may be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents. The issue is whether a qualifying SPE (or its designee or agent) may determine the terms of beneficial interests issued to third parties after inception of the qualifying SPE either prior to or after the derecognition by the transferor of the assets that the beneficial interests represent. A further issue is, if a qualifying SPE is permitted to determine the terms of newly issued beneficial interests, whether it would also be permissible for the transferor to have the ability to direct the qualifying SPE to prepay previously issued beneficial interests with proceeds of newly issued beneficial interests.

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 02-18, "Accounting for Subsequent Investments in an Investee after Suspension of Equity Method Loss Recognition." APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, indicates in paragraph 19(i) that an "investor ordinarily should discontinue applying the equity method when the investment (and net advances) is reduced to zero and should not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee" (footnote reference omitted). The issue is how an investor should account for a subsequent investment in an investee after the suspension of equity method losses has occurred.

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 can also 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, they 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.