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EITF Roundup

Audit and Enterprise Risk Services

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Table of Contents

*Final consensus was reached.

by Brandon Coleman

This issue of *EITF Roundup* covers the June 30/July 1, 2004 meeting of the Emerging Issues Task Force (EITF or the "Task Force"). EITF consensuses are subject to ratification by the Financial Accounting Standards Board (FASB) at a regular weekly FASB meeting and are not final until ratified. Official EITF minutes are posted to the Deloitte Accounting Research Tool (DART) Web site. To subscribe to DART, visit www.deloitte.com/us/dart. EITF meeting materials distributed to the Task Force prior to the meeting and final meeting minutes are made available on the FASB's Web site at www.fasb.org/eitf/eitf_meeting_materials.shtml.

The Task Force discussed the following topics at the June 30/July 1, 2004 meeting:

Issue No. 02-14, *Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock*

Companies sometimes have the right to significantly influence the operating and financial policies of another entity and share in a substantial portion of the economic risks and rewards without owning a voting interest in that entity. When an investor has the ability to exercise significant influence over an investee through economic interests other than common stock, should the investor apply the equity method of accounting to its investment? Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, read literally, only applies to investments in voting common stock. Consequently, many accountants are concerned that instruments that do not take the legal form of common stock (e.g., a convertible preferred instrument) are devised to inappropriately avoid the equity method.

At the June/July meeting, the Task Force reached a consensus that an investor should only apply the equity method of accounting when it has investments in either common stock (as already required by APB 18) or **in-substance common stock** of a corporation,[1] provided that the investor has the ability to exercise significant influence over the operating and financial

1 This Issue does not apply to investment accounted for under American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) No. 78-9, *Accounting for Investments in Real Estate Ventures*, or EITF Issue No. 03-16, *Accounting for Investments in Limited Liability Companies*.

policies of the investee. The Task Force defined in-substance common stock as an investment that has risk and reward characteristics that are substantially similar to that of the common stock of the investee. An investor should consider the following three characteristics when determining whether an investment is substantially similar to the common stock of the investee (thus requiring application of the equity method provided that the investor has the ability to exercise significant influence):

1. Whether the instrument has subordination characteristics similar to the common stock of the investee.

   If an investment has a **substantive liquidation preference** over the common stock of the investee, it is not substantially similar to the common stock. Accordingly, an investor should determine whether any liquidation preference is substantive. Examples of nonsubstantive liquidation preferences are as follows:

   - The instrument has a stated liquidation preference that is not significant when compared to the investor's cost.
   - The liquidation preference does not significantly affect the value of the instrument. This would be the case, for example, if the amount of the stated liquidation preference is meaningful but there is little or no equity subordinate to the instrument from a fair value perspective. That is, this determination must be based on fair value of the common stock at the date of determination, not its book value.

2. The instrument has risks and rewards substantially similar to ownership of the common stock of the investee.

   All of the specific facts and circumstances at the date of determination should be considered to analyze this characteristic. If an investment is not expected to participate in the earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to the common stock of the investee, the investment is not substantially similar to the common stock. If the investee pays dividends and the investment participates currently in dividends in a manner similar to the common stock of the investee, then that is an indicator the investment is similar to the common stock. Likewise, if the investor has the ability to convert the investment into the common stock without any significant restrictions or contingencies that prohibit the investor from participating in the capital appreciation of the investee in a manner that is substantially similar to the common stock, the conversion feature is an indicator that the investment is substantially similar to the common stock.

3. Whether the instrument does not require the investee to transfer **substantive** value to the investor unless the common stock also has the feature.

   The investor should consider whether its investment requires the investee to transfer substantive value or allows the investor to require the investee (e.g., in the case of a puttable instrument) to transfer substantive value. For example, if the investment has a substantive mandatory redemption provision other than in a liquidation event, the investment most likely would not be substantially similar to the common stock of the investee.

If all of the above characteristics are met, the instrument is in-substance common stock. If the determination about whether the investment is substantially similar to the common stock cannot be reached based solely on the evaluation of the three characteristics, the investor should analyze whether the changes in the fair value of the investment are expected to be highly correlated with the changes in the fair value of the common stock of the investee. Many times, it may be clear that the fair value is not highly correlated based on the consideration of the three characteristics (e.g., the investment has a substantive liquidation preference). However, a quantitative analysis may be necessary to determine whether the fair value of the investment is highly correlated to the fair value of the common stock.

For investments entered into subsequent to the adoption of this consensus, the initial determination should be made on the date at which the investor obtains its investment, provided the investor has the ability to exercise significant influence over the operating and financial policies of the investee. The determination of whether an instrument is substantially similar to the common stock of the investee and whether the equity method applies, should be reconsidered if one or more of the following occur:

1. The contractual terms of the investment change resulting in a change to any of the characteristics considered for the initial determination.
2. There is a significant change in the capital structure of the investee, including the investee receiving additional subordinated financing.
3. The investor obtains an additional interest in an investment in which the investor has an existing interest.
4. The investor obtains the ability to exercise significant influence over the operating and financial policies of the investee.

The consensus in this Issue (if ratified by the Board), should be applied in the first reporting period beginning after September 15, 2004. The initial determination of whether existing investments (assuming the investor has the ability to exercise significant influence over the operating and financial policies of an investee) are in-substance common stock should be made as of the date this Issue is first applied. The consensus requires a company to report the change and recognize in net income the cumulative effect of a retroactive computation as if the investment had been accounted for under the equity method from initial acquisition. If this

information is not available, a cumulative effect adjustment is still required for the period in which the change is adopted; however, the cumulative effect adjusts the investment to an amount equal to the investor's ownership percentage applied to the investee's net assets determined in accordance with generally accepted accounting principles (GAAP).

The Securities and Exchange Commission (SEC) staff has long had a policy that, when appropriate, in-substance common stock should be accounted for under the equity method. The SEC observer cautioned that the staff will **require restatement as a correction of an error** (as opposed to the cumulative effect of adopting the consensus) for abusive situations involving in-substance common stock investments.

For instruments that are not common stock or in-substance common stock but were accounted for under the equity method of accounting prior to the consensus on this Issue, the equity method of accounting should be discontinued effective for reporting periods beginning after September 15, 2004. Previously recognized equity method earnings and losses should not be reversed. The investor needs to evaluate whether the investment should be prospectively accounted for under Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, or the cost method under APB 18.

As a final consensus on this Issue was reached, no further discussion is expected.

Issue No. 03-9, *Determination of the Useful Life of Renewable Intangible Assets under FASB Statement No. 142,* Goodwill and Other Intangible Assets

The value of an intangible asset (for purposes of accounting for a business combination under SFAS No. 141, *Business Combinations*) is often based on discounted cash flows that effectively span an indefinite period. Implicitly, this approach presumes that the underlying contract will be renewed.

SFAS 142 requires an entity to determine whether an intangible asset has a finite useful life or indefinite useful life. This classification results in different amortization approaches and impairment tests for the intangible asset. A number of companies have assigned contractually related intangibles (e.g., network affiliation rights, FCC licenses) an indefinite life, consistent with the valuation of the intangible under SFAS 141. Some have expressed concern that more intangible assets have been determined to have an indefinite life than was intended under SFAS 142.

Paragraph 11(d) of SFAS 142 provides that one of the factors in estimating the useful life of an intangible asset is:

> "Any legal, regulatory, or contractual provisions that enable renewal or extension of the asset's legal or contractual life without **substantial cost** (provided there is evidence to support renewal or extension, and renewal or extension can be accomplished without **material modifications** of the existing terms and conditions)." [Emphasis added]

In this Issue, the Task Force has been asked to provide guidance for evaluating how "substantial cost" and "material modifications" affect the determination of the useful life of an intangible asset. Previously, the Task Force tentatively agreed that the analysis of whether the useful life of an intangible asset should extend beyond its contractual term should be based on assumptions of renewal or nonrenewal that are consistent with assumptions of marketplace participants.

At the June/July meeting, the Task Force discussed two views, proposed by the FASB staff, to address the Issue. Each view is based on the premise that if the underlying contract does not have an indefinite life, then two or more intangible assets exist — one related to the finite-lived contract and one or more intangible assets related to the probability of renewal:

View A: A renewable intangible asset is in substance a single intangible asset if an entity is substantially indifferent to acquiring the renewable intangible asset or acquiring a hypothetically identical intangible asset that does not require renewal. This approach would consider the probability of renewal, whether significant incremental renewal costs in order to achieve renewal are expected that would not otherwise be incurred, and whether modifications to the existing terms and conditions are expected.

View B: A renewable intangible asset is in substance a single intangible asset if renewal is reasonably assured. This approach utilizes the concept of "reasonably assured" as a surrogate for evaluating substantial costs and material modifications because of the belief that there is a correlation between (1) the risk of nonrenewal and (2) the expectation of substantial costs to be incurred and material modifications to be made in renewing the contract.

No consensus was reached on this Issue. However, the Task Force appeared to lean towards View B. The Task Force generally agreed that in determining if a contract can be renewed without substantial costs, the costs that an entity should evaluate are those that the entity would not otherwise incur if the contract was not subject to renewal. The Task Force asked the FASB staff to further develop the meaning of material modifications.

Further discussion of this Issue is expected.

Issue No. 03-13, *Applying the Conditions in Paragraph 42 of FASB Statement No. 144,* Accounting for the Impairment or Disposal of Long-Lived Assets, *in Determining Whether to Report Discontinued Operations*

Issue No. 03-13 was added to the agenda to address a number of practice questions that have arisen in applying the criteria in paragraph 42 of SFAS 144. SFAS 144 intended to expand the reporting of discontinued operations as compared to the outcome under its predecessor, APB Opinion No. 30, *Reporting the Results of Operations — Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. However, paragraph 42 of SFAS 144 notes that classification as discontinued operations is appropriate only if the following conditions are met:

> "(a) the operations and cash flows of the component have been (or will be) **eliminated** from the ongoing operations of the entity as a result of the disposal transaction and (b) the entity will not have any **significant continuing involvement** in the operations of the component after the disposal transaction." [Emphasis added]

In practice, the above requirements often have been interpreted in a very restrictive fashion (i.e., **any** and **all** cash flows must be eliminated). Many have questioned whether the literal words of paragraph 42 contradict the Board's stated intention of expanding the reporting of discontinued operations.

The specific issues to be addressed concern (1) which cash flows of the discontinued component should be considered in the determination of paragraph 42(a) and (2) what types of continuing involvement constitute significant continuing involvement under paragraph 42(b). A supplementary issue addressed in Issue No. 03-13 is the appropriate (re)assessment period for determining whether the conditions for discontinued operations reporting are met under paragraph 42.

To illustrate the Issue, consider whether the disposed components in the following two examples constitute a discontinued operation:

- A retailer closes all of its stores in one region (assume these represent a *component* of the entity). However, the customers of the closed stores can still purchase from the retailer's Web site and catalog. Have all cash flows of the component been eliminated if some of its customers are still purchasing product from the retailer?
- A real estate company sells one of its properties in a region, but enters into a one-year management agreement to operate the disposed property. Have the cash flows been eliminated? Does the management agreement constitute significant continuing involvement? If the company has other rental properties in the same region, does this impact the analysis because the company still has cash flows related to rental properties in that market?

At the November 2003 meeting, the Task Force reached a tentative conclusion on the reassessment period. The assessment should be made during the period that includes the point at which the component initially meets the criteria to be classified as held-for-sale and one year after the date on which the component is actually disposed of. The assessment should be based on all facts and circumstances, including management's intent and ability to eliminate the cash flows of the disposal component from its operations and management's intent and ability not to have significant continuing involvement in the operations of the disposed component. If at any time the criteria are not expected to be met within one year after the disposal date, the component's operations should be reclassified from discontinued operations. If at any time the criteria are expected to be met within one year after the disposal date, the component's operations should be reclassified to discontinued operations.

At the June/July meeting, the Task Force discussed a model developed to determine whether cash flows of the disposed component have been "eliminated" from the continuing entity. The proposed model distinguishes between **direct** and **indirect** cash flows. This model establishes that if any **significant** cash flows of the disposed component that remain with the continuing entity are direct, the cash flows have not been eliminated and the operations of the component should not be presented as a discontinued operation.

Direct cash flows are those:

- Cash inflows or outflows expected to be recognized by the remaining entity as the result of the migration of revenues or costs, or
- Cash inflows or outflows from a continuation of activities. Many times this will be the case when a vertically integrated company sells one of its components. For example, assume a manufacturer sells its product to a company-owned retailer store. If the company sells its manufacturing business but continues to purchase bicycles from the sold manufacturing business, this would be a continuation of activities.

The Task Force did not support a bright line threshold in determining "significant" as used in the above paragraph. The determination of whether direct cash flows are significant will depend on the facts and circumstances. However, some Task Force members proposed requiring disclosures of the revenues, costs, and activities from the disposed component expected to continue in the remaining entity.

Many Task Force members expressed general support of the direction of the model; however, the Task Force was not asked to reach a consensus.

Further discussion of this Issue is expected.

Issue No. 04-1, *Accounting for Preexisting Relationships between the Parties to a Business Combination*

This Issue addresses the accounting for a preexisting relationship when the parties to the relationship enter into a business combination. Specifically, the issue is whether the business combination should be viewed as a single transaction or one with two or more elements (e.g., a business combination and a de facto settlement of the previous relationship(s)). At the March meeting, the Task Force tentatively concluded that the consummation of a business combination between two parties that have a preexisting relationship should be evaluated to determine if a settlement of a preexisting relationship exists, requiring accounting separate from the business combination. Because of the above tentative conclusion, the Task Force must address the recognition and measurement of a settlement of a preexisting relationship and whether certain reacquired rights should be recognized as intangible assets, apart from goodwill.

At the June/July meeting, the Task Force discussed the following proposed model for accounting for a business combination involving a preexisting relationship:

Step 1: Allocate the cost of the acquired entity to the identifiable assets acquired and liabilities assumed (including any identifiable assets and liabilities related to the preexisting relationship) based on their estimated fair values at the date of the acquisition with any residual recognized as goodwill in accordance with SFAS 141.

Step 2: Segregate the identifiable assets and liabilities related to the preexisting relationship.

Step 3: For each asset (liability) identified in Step 2, determine how the amount allocated to each asset (liability) in Step 1 would be recognized had that amount been paid (incurred) absent the business combination.

Several members questioned certain aspects of the model: (1) anomalous results if preexisting contracts contain a non-fair value settlement provision, (2) the potential for recording a gain (for a favorable settlement) arising in the context of a business combination, and (3) the effects of customer-related-type intangible assets that exist between the companies involved in the business combination.

No consensus was reached at the June/July meeting. The Task Force asked the FASB staff to update the Issue Summary with more examples addressing the concerns in the previous paragraph.

Further discussion of this Issue is expected.

Issue No. 04-5, *Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights*

This Issue revisits the same practice problem that was left unresolved in Issue No. 98-6, *Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Approval or Veto Rights*. Given the legal status and broad authority of a general partner (vs. the constrained role that limited partners can take in day-to-day operations), the Issue involves identifying the circumstances when it is appropriate or inappropriate for the general partner to consolidate the limited partnership.

As a result of the diversity in practice and the conflict between the concept of **participating rights** in 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 of Veto Rights*, for corporate entities, and **important rights** in SOP 78-9, *Accounting for Investments in Real Estate Ventures*, for real estate partnerships (analogized to for other partnerships), the Task Force developed a framework in Issue No. 98-6 to address the practice question of when a general partner should consolidate a limited partnership. However, no consensus was reached, partially because many believed the EITF, whose guidance is a lower level of GAAP than an SOP, could not amend or interpret SOP 78-9. Subsequent consolidation guidance never resolved the practice issue and diversity in practice remains.

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46(R)), renewed the debate over what considerations are relevant in making the evaluation of whether the general partner should consolidate a limited partnership. Especially important are so-called "kick-out rights," referring to the conditions under which limited partners can remove the general partner. Kick-out rights vary from partnership to partnership, including (but not limited to) the percentage of limited partner support required for removal.

The guidance on substantive kick-out rights of a decision maker in FIN 46(R) (paragraph B20) led to an SEC staff speech (December 2003) that indicated that if a general partner is to base its determination of whether to consolidate a limited partnership on the rights of the limited partners to "kick-out" the general partner, the determination should consider the guidance in FIN 46(R) as to whether the kick-out rights are substantive (e.g., could be exercised by a simple majority of limited partners not related to the general partners without barriers to exercising such right).

At the June/July meeting, the Task Force discussed the scope and direction of the Issue. The Task Force concluded that any consensus will only apply to limited partnerships that are not variable interest entities. Also, this Issue will only address

limited partnerships with a single general partner or limited partnerships with more than one general partner but all of the general partners are related to each other.

The Task Force agreed that the framework proposed in Issue No. 98-6 is a good starting point — it proposes a framework that presumes consolidation of the limited partnership by the general partner unless one or both of the following characteristics is met:

Step 1: The limited partners have the substantive ability to remove the general partner (that is, kick-out rights).

Step 2: The limited partners have substantive participation rights as described in Issue No. 96-16.

The Task Force did not reach any specific conclusions on the above proposed framework. At a future meeting, the Task Force will further discuss specifics of the framework, and consider whether limited partner liquidation rights or withdrawal rights also should be considered in overcoming the presumption of consolidation by the general partner. In addition, the Task Force will consider whether rights included in Issue No. 96-16 as substantive participation rights are appropriate considerations for limited partnerships, as well as whether other rights not included in Issue No. 96-16 are appropriate for determining if the rights of limited partners should preclude consolidation by the general partner.

Further discussion of this Issue is expected.

Issue No. 04-6, *Accounting for Post-Production Stripping Costs in the Mining Industry*

This Issue was added to the agenda as part of several issues identified by a mining industry Working Group. Although some Task Force members believe that the FASB Board should take on a broad project to provide a comprehensive model of accounting for the mining industry, the Task Force generally agreed to keep this Issue narrow in addressing stripping costs during post-production.

Mining companies usually remove overburden and other mine wasting material (referred to as stripping costs) in order to access mineral deposits. During the development stage of a mine (before production begins), typically these costs are capitalized as part of the cost of the mine. These capitalized costs typically are amortized over the productive life of the mine using the units of production method.

During production, the question arises as to whether these costs (referred to as post-production stripping costs) should be expensed, deferred and amortized, or capitalized as inventory costs. Diversity in practice has arisen because these stripping costs may benefit both current period production (because removal of the waste is necessary to extract the material mined in the current period), as well as benefiting future periods (because the costs facilitate access to additional minerals to be mined in the future).

The Task Force discussed the following views regarding the accounting for post-production stripping costs:

View A: Expense as incurred.

View B: Defer and recognize in earnings using a life-of-mine stripping ratio, precluding, however, the recognition of a liability in periods when the actual stripping ratio is less than the life-of-mine stripping ratio.[2]

View B': Same as View B without the liability preclusion.

View C: Include as a component of mineral inventory cost subject to the provisions of AICPA Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*. Depending on the configuration of the mineral deposits, the post-production stripping costs could often lead to a lower of cost or market inventory adjustment under this method.

View D: Presumed to be a cost of current production that can be overcome if it can be clearly demonstrated that the stripping cost incurred does not benefit the current period's production but, rather, solely benefits future production of the mine.

No consensus was reached on this Issue. However, the Task Force did agree to remove View D and View B' from consideration. The SEC observer indicated that the SEC staff generally objects to a mining company capitalizing deferred stripping costs as a discrete asset — that is one that is neither a component of the accumulated costs of the mine nor as a component of inventory. The Task Force asked the Working Group to further develop Views A, B, and C, and make a recommendation to the Task Force.

Further discussion of this Issue is expected.

Issue No. 04-7, *Determining Whether an Interest Is a Variable Interest in a Variable Interest Entity*

This Issue was added to the agenda due to the significant diversity in practice in identifying whether certain derivatives or forward contracts are variable interests under FIN 46(R), *Consolidation of Variable Interest Entities*. FIN 46(R) provides that contracts that create variability are not variable interests and contracts that absorb variability are variable interests. However, many times a derivative or forward contract swaps one type of risk (which creates variability) for another (which absorbs variability). Therefore, the question has arisen on how to determine what types of risks are to be considered in determining whether the contract or instrument is absorbing variability, and thus, is a variable interest.

2 Life-of-mine stripping ratio is calculated based on an estimate of the waste to be removed from the mine divided by the ore to be removed from the mine.

Four general approaches have been developed to determine whether an interest is a variable interest as follows:

View A: Based on whether the interest absorbs **fair value** variability.

View B: Based on whether the interest absorbs **cash flow** variability.

View C: Based on whether the interest absorbs **either cash flow or fair value** variability.

View D: Based on the design of the entity which may require consideration of a multitude of factors, such as the role each party has in the entity's activities, terms of the interest being analyzed, the expectations of the parties involved with the entity, and how the entity was marketed to its investors.

Each one of these general approaches is supportable by respective references within FIN 46(R). Further, the selection of one approach versus another often results in different consolidation conclusions for identical economic transactions.

At the June/July meeting, the Task Force discussed elements of the four approaches and their application to simple entity structures. The discussions were largely inconclusive. As a result, the Task Force instructed the FASB staff to further develop the approaches and examples for further discussion at the next EITF meeting.

Issue No. 04-8, *Accounting Issues Related to Certain Features of Contingently Convertible Debt and the Effect on Diluted Earnings per Share*

Contingently convertible debt instruments, commonly referred to as Co-Cos, are structured financial instruments that add a contingent feature to a convertible debt instrument. Co-Cos are generally convertible into common shares of the issuer after the market price of the issuer's common stock exceeds a predetermined threshold for a specified period of time (market price trigger). For example, a typical Co-Co might be issued for $1,000 and convertible into ten shares of common stock (implying a conversion price of $100). However, the investor does not have the right to convert unless the market price of the issuer's stock exceeds $120 for a specified consecutive number of days. Frequently, a Co-Co includes other complex features (e.g., parity provisions and contingent call or investor put rights).

Co-Cos have found broad acceptance in the capital markets. One likely reason for their popularity is the advantageous earnings per share (EPS) treatment afforded to Co-Cos when compared to conventional convertible debt instruments. Unless the effect is anti-dilutive, a conventional debt instrument almost always is included in the computation of diluted EPS (even when the current stock price indicates that it is uneconomical to convert). In contrast, Co-Cos typically are excluded from diluted EPS until the market price trigger is met by analogy to the guidance stated in SFAS 128, *Earnings per Share*, on contingently issuable shares.

The Task Force reached a tentative conclusion that Co-Cos should be included in diluted EPS in ALL periods (except when inclusion is anti-dilutive) regardless of whether the contingency is met and regardless of whether the market price contingency is substantive. This decision was based on the conclusion of the Task Force that a Co-Co is contingently convertible, not contingently issuable as provided in SFAS 128, and thus, is no different than a conventional convertible debt instrument. Essentially, the Task Force did not believe the circumstances described in the previous paragraph warranted different EPS treatment for Co-Cos.

The tentative conclusion surprised many observers of the EITF process. The materials for the meeting did not include an alternative supporting the tentative conclusion nor had the FASB staff concluded that the treatment was warranted when considering FASB Staff Position FAS 129-1, *Disclosure Requirements under FASB Statement No. 129,* Disclosure of Information About Capital Structure, *Relating to Contingently Convertible Securities*.

The question of whether this conclusion is a valid interpretation or a technical amendment of SFAS 128 will be explored by the FASB staff, which may impact whether the conclusion would be established in authoritative guidance through this EITF Issue or a Board-directed FASB Staff Position. The Task Force also reached the conclusion that, if a final consensus is reached, retroactive restatement of earnings per share for periods ending after December 15, 2004, would be required. Due to the potential far-reaching impact this decision may have on practice, the tentative conclusion will be posted for public comment on the FASB's Web site. The Task Force will consider comments at its September 29-30 meeting.

Agenda Committee Report Items

Removal of Issue No. 03-S, *Application of FASB Statement No. 142*, Goodwill and Other Intangible Assets, *to Oil and Gas Companies*

Issue No. 03-S was added to the agenda as part of several issues arising from a report by a mining industry Working Group. This Issue was to be based on whether the scope exception from accounting for drilling and mineral rights in the oil and gas industry, provided in paragraph 8(b) of SFAS 142, also exempted these companies from the balance-sheet classification and disclosures.

The Task Force concluded that because the accounting framework in SFAS No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, is based on the level of established reserves, not whether an asset is tangible or intangible, it was appropriate for the scope exception to apply

to all aspects of SFAS 142. Therefore, the Task Force removed this Issue from its agenda. A FASB Staff Position will be announced shortly to clarify this exception.

Addition of Segment Reporting Issues

The Agenda Committee added two associated issues related to the determination of whether to aggregate operating segments that do not meet the quantitative thresholds listed in paragraph 18 of SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*. The two Issues are as follows:

- The Meaning of Similar Economic Characteristics — significant diversity in practice exists in determining whether the long-term and future expected financial results of operating segments must be similar to allow aggregation of two or more operating segments. For example, assume a retailer has two internal operating segments, a store brand with a 40 percent average gross margin and a national brand with a 20 percent average gross margin. However, the two operating segment have similar sales growth and otherwise meet all of the other criteria for aggregation in paragraph 17(a)-(e) of SFAS 131. Despite having dissimilar average gross margins, may these operating segments be aggregated under paragraph 17 of SFAS 131?
- Aggregation of Operating Segments That Do Not Meet the Quantitative Thresholds — paragraph 19 of SFAS 131 provides that in order to aggregate such operating segments, the segments must "share a majority of the aggregation criteria listed in paragraph 17." Are the segments required to:
  - o Have similar economic characteristics **and** be similar in a majority of the aggregation criteria listed in paragraph 17(a)-(e), or
  - o Be similar in a majority of the aggregation criteria listed in paragraph 17 (**which includes** similar economic characteristics and the criteria listed in paragraph 17(a)-(e))?

These Issues will be discussed at a future EITF meeting.

Issue Not Added to the Agenda — *Accounting for Distributions Fees by Distributors of Mutual Funds That Do Not Have Front-End Sales Charges and the Distributors Transfer the Rights to Such Fees*

Mutual funds that do not have front-end sales charges often have annual distribution fee charges (commonly referred to as 12b-1 fees). EITF Issue No. 85-24, *Distribution Fees by Distributors of Mutual Funds That Do Not Have Front-End Sales Charges*, requires a distributor to defer the recognition of the fee revenue until it receives the fee. Some distributors have entered into transactions in which they exchange the right to future distribution fees for a cash payment. In certain transactions, the buyer obtains virtually all of the economic risks and rewards associated with the future fees. Based on receiving a lump-sum payment for the future fees, some distributors have recognized revenue under Issue No. 85-24. These distributors have concluded that the cash received from investors should not be recognized as a liability under EITF Issue No. 88-18, *Sales of Future Revenues*.

Some have questioned whether it is appropriate for a company to recognize revenue upon transfer of its future distribution fee revenue. The Agenda Committee decided not to add this issue to the EITF's agenda primarily because of the Board's pending project on revenue recognition. However, the FASB staff has indicated that it will explore whether it should issue a FASB Staff Position to address the accounting for distribution fees when the distributor continues to provide services to the investment entity.

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