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EITF Roundup

Audit and Enterprise Risk Services

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** Removed from the agenda.

by Brandon Coleman

This issue of *EITF Roundup* covers the September 29-30, 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 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 September 29-30, 2004 meeting:

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 business combination accounting under FASB Statement No. 141, *Business Combinations*) is based on discounted cash flows that often span an indefinite period. Implicitly, this approach presumes that any underlying renewable contract will be renewed many times.

Statement 142 requires an entity to determine whether an intangible asset has a finite or indefinite useful life. 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 asset under Statement 141.

The purpose of this publication is to briefly describe matters discussed at the most recent meeting of the Emerging Issues Task Force. This summary was prepared by the National Office Accounting Standards and Communications Group of Deloitte & Touche LLP ("Deloitte & Touche"). Although this summary of the discussions and conclusions reached is believed to be accurate, no representation can be made that it is complete or without error. Official meeting minutes are prepared by the Financial Accounting Standards Board staff and are available approximately two weeks after each meeting. The official meeting minutes sometimes contain additional information and comments; therefore, this meeting summary is not a substitute for reading the official minutes. In addition, tentative conclusions may be changed or modified at future meetings.

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Paragraph 11(d) of Statement 142 provides the considerations in estimating the useful life of an intangible asset:

> 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 was asked to provide guidance for evaluating how "substantial cost" and "material modifications" affect the determination of the useful life of an intangible asset. The Task Force generally agreed that limiting the useful life of a renewable intangible asset to a period that is shorter than it is expected to contribute future cash flows is inconsistent with the definition of *useful life* under Statement 142 and the market participant approach for determining fair value in Statement 141.

At the September meeting, the Task Force continued to express significant concern about the ability to resolve this Issue because it relates to inconsistencies between Statement 141 and Statement 142 that only the FASB can resolve. Accordingly, the Task Force discontinued discussion of the topic and recommended the FASB address this inconsistency in a FASB project or Board-directed FSP. The majority of the Board attending the EITF meeting expressed a willingness to take on the issue but did not commit to a timetable.

No further discussion of this Issue is expected by the Task Force.

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*

This Issue was added to the agenda to address a number of practice questions that have arisen in applying the criteria in paragraph 42 of Statement 144. It appears that the Board intended Statement 144 to result in an increase in the number of entities reporting discontinued operations as compared to 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 Statement 144 appears to contravene this goal by including the following requirements:

> (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 restrictive fashion (i.e., any and all cash flows must be eliminated). Accordingly, questions have proliferated about whether the literal words of paragraph 42 contradict the Board's stated intention of expanding the reporting of discontinued operations.

The specific issues addressed are: (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). Issue No. 03-13 also addresses the appropriate (re)assessment period for determining whether the conditions under paragraph 42 are met.

To illustrate a key issue, consider whether the disposed component in the following example should be reported as a "discontinued operation."

Example 1

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 continue to purchase the same type of product from the retailer's Web site and catalog. Thus, some of the customers of the disposed component are expected to "migrate" as customers of the retailer's Web site and catalog. Have all cash flows of the component been eliminated if some of the customers of the disposed component are still purchasing the same products from the retailer? (See below for analysis.)

At the meeting, the Task Force reached a **tentative** consensus that classification of a disposed of or held-for-sale component, as a discontinued operation, is only appropriate if the ongoing entity:

Step 1: Expects to have no **continuing "direct" cash flows** (interpretation of paragraph 42(a)), and

Step 2: Does not retain or expect to retain an interest, contract, or other arrangement sufficient to enable it to exert significant influence over the disposed component's operating and financial policies after the disposal transaction (interpretation of paragraph 42(b)).

Step 1:

Direct cash flows of a component include gross cash flows (cash inflows and cash outflows) that are associated with continuing revenue-producing and/or cost-generating activities of that component. Direct cash flows are when the ongoing entity is expected to recognize:

- **Significant** cash inflows or outflows as the result of a migration[1] of revenues or costs from the disposed component after the disposal transaction, or
- **Significant** cash inflows or outflows from a continuation of activities between the ongoing entity and the disposed component after the disposal transaction. For example, assume a manufacturer sells a product to company-owned retailer stores. If the company sells its manufacturing business but continues to purchase the product for its stores from the sold manufacturing business, the ongoing purchases represent a continuation of activities.

The Task Force rejected establishing a bright-line threshold to determine "significant." The determination of whether direct cash flows are significant will depend on facts and circumstances.

Example 1 (continued from above)

The retailer recognized $1 million in annual revenues from its disposed component prior to disposal. Some of the customers of the disposed component are expected to "migrate" as customers of the retailer's Web site and catalog, which is expected to result in the ongoing entity recognizing $500 thousand in annual revenues. That is, the ongoing entity is expecting 50 percent migration of revenues. Since this represents a significant continuation of direct cash flows, the disposed component should not be displayed in discontinued operations.

The Task Force also determined that if the ongoing entity continues to sell a commodity[2] into an active market after the disposal transaction, migration occurs.

Example 2

A company owns an oil field in one region and sells oil into an active market. The company disposes of the oil field but brings another field of similar capacity online. The company will sell the oil into the same active market. In this example, migration is expected to occur, and if significant, the company would not report the disposed component as a discontinued operation.

In short, the Task Force defined "direct cash flows" in a manner that permits the continuation of insignificant cash flows between the discontinued operation (or the customers of the discontinued operation), and the ongoing entity. This reconciles paragraph 42(a) of Statement 144 (requiring an **elimination** of cash flows) to the intention of the Board to increase the number of entities reporting discontinued operations.

1 A migration is when the ongoing entity expects to continue to generate revenues and cost of sales from the sale of similar products or service to specific customers of the disposed component. This test requires a consideration of the expected gross revenues and costs that will remain in the ongoing entity as a result of migration compared to the total revenues and costs that the disposed component would have recorded, absent the disposal.

2 Based on the Task Force recommendation, *commodity* is expected to be loosely defined as interchangeable units that have an immediate marketability at quoted prices.

Step 2:

The Task Force determined that the relevant consideration for significant continuing involvement is whether the entity will be able to exert significant influence over the operating and financial policies of the disposed component. For example, an equity method investment or other contract that allows the ongoing entity to exert significant influence is significant continuing involvement. Retention of risk, or ability to obtain benefits associated with the ongoing operations of the disposed component, is not explicitly considered by themselves to be continuing involvement for the purpose of this Issue. However, the Task Force believes the retention of risks and rewards may be relevant in an overall assessment of whether the ongoing entity can exert significant influence.

The Task Force also reached a tentative consensus that the appropriate assessment period should include the point at which the component initially meets the criteria to be classified as held for sale, and one year after the date the component is actually disposed. The assessment should be based on all facts and circumstances, including management's intent and ability to eliminate the cash flows of the disposed component from its operations and management's intent and ability regarding significant continuing involvement. An entity is required to reassess its previous evaluation only when events or circumstances make it likely that the criteria in paragraph 42 will (or will no longer) be met within one year after the disposal date.

The tentative consensus requires the following disclosures of information for each discontinued operation that generates continuing cash flows or results in continuing involvement:

- The nature of the activities that give rise to continuing cash flows,
- The period of time continuing cash flows are expected to be generated,
- The principal factors used to conclude that the expected continuing cash flows are not direct cash flows of the disposed component,
- The amount of intercompany revenues, if any, that are no longer eliminated as a result of the disposal of the component, and
- A description of the types of continuing involvement, if any, that the entity will have subsequent to the disposal transaction.

The Task Force recommended that a draft abstract of this tentative consensus be posted for public comment prior to the November meeting. The effective date would be for a component of an entity that has been either disposed of, or classified as held for sale, in periods beginning after December 15, 2004.

Further discussion of this Issue is expected at the November meeting when the Task Force will consider comments received on the draft abstract.

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 subsequently enter into a business combination. Specifically, the Issue is whether the business combination should be viewed as a single transaction or as one with multiple elements (i.e., a business combination and a *de facto* settlement of the previous relationship(s)). The Issue also addresses 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 September meeting, the Task Force reached a consensus (reaffirming a previous conclusion) that consummation of a business combination between two parties that have a preexisting relationship(s), are multiple element transactions. The Task Force also developed a model to address the accounting for the settlement of the preexisting relationship as follows:

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 Statement 141.

Step 2: Segregate the identifiable asset(s) and liability(ies) related to the preexisting relationship(s).

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. (See executory contract in Example 1 below for a departure from the pure fair value principal in Step 2.)

The Task Force determined that this consensus should be applied to the following categories of transactions as follows:

Executory contracts: The settlement amount should be measured at the lesser of (a) the amount by which the contract is favorable or unfavorable to market, or (b) any stated settlement provisions in the contract held by the counterparty to which the contract is unfavorable.

Example 1

Company X purchases supplies from Company Y at fixed rates. The contract has unfavorable pricing to X (favorable to Y or a marketplace participant buying Y out of the contract) that a marketplace participant would value at $3. A marketplace participant also would place a value of $1 on the selling effort and other relationships of having the contract in place. With three years remaining under the supply agreement, X pays $50 (net of liabilities assumed) to acquire Y.

Company X should recognize a loss on settlement of the supply contract of $3 related to the unfavorable pricing terms compared to market.[3] The remaining $47 of purchase price, including the $1 related to the preexisting contract's value representing selling effort and other relationships, should be accounted for as part of the business combination.

Lawsuits: The settlement amount would be equal to the difference between the fair value of the lawsuit and any preexisting recorded liability. The Task Force concluded that an acquirer should recognize the hypothetical settlement gain,[4] or loss, as a result of this multiple element transaction.

Example 2

Company X is currently suing Company Y. Company X purchases Y for $300. The estimated fair value of the lawsuit at the business combination date was $50.

Company X should recognize a gain on settlement of $50 and adjust the purchase price of Company Y to $350.

Reacquired rights: The settlement amount should be measured in a manner consistent with that of an executory contract. The remaining value, related to the reacquired right, should be included as part of the business combination.

Example 3

Company X acquired the business of its operating franchisee, Franchise A. Company X pays $100 (net of liabilities assumed) to acquire A. Assume the total fair value of A includes an intangible asset with a fair value of $40 related to the exclusive rights granted to A by X in a specified territory. Assume the terms of the agreement are at market rates.

Company X should not recognize any settlement because the pricing is at market terms. Company X should include the entire $40 related to the exclusive rights in the purchase price of Franchise A.

The Task Force also reached a consensus that a reacquired right should be recognized as an intangible asset apart from goodwill because it meets the separability criteria of Statement 141. That is, there is evidence of an exchange transaction for the asset as the acquirer had sold the right previously.

The final consensus requires the following disclosures:

- The nature of the preexisting relationship,
- The fair value of the acquired entity's assets and liabilities that were settled, including how fair value was determined, and
- The amount of settlement gain or loss recognized.

3 On a pure fair value basis, Company X would have assigned $4 to the contract.

4 The Task Force expressed concern about allowing a gain to be recorded as a result of accounting for the settlement of a lawsuit as a separate element from the business combination. However, the Task Force concluded that there should be symmetry in accounting for settlements.

This consensus, if ratified by the Board at its October 13, 2004 meeting, must be applied prospectively to business combinations and goodwill impairment tests completed in reporting periods beginning after Board ratification. Early application is permitted for business combinations completed in periods for which financial statements have not been issued. Entities are prohibited from reclassifying amounts recognized in prior periods.

No 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*

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) which 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 (i.e., could be exercised by a simple majority of limited partners — not related to the general partners — without barriers to exercising such right).

This Issue revisits the same practice problem that was left unresolved in EITF Issue No. 98-6, *Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Approval or Veto Rights*.

The Issue is limited to investments in which the investor is the sole general partner in a limited partnership or similar entity (such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership) and the limited partnership is not a variable interest entity under FIN 46(R).

At the September meeting, the Task Force discussed a model in which a sole general partner[5] in a limited partnership is presumed to control that limited partnership, and, therefore, should include the limited partnership in its consolidated financial statements unless either:

Step 1: The limited partners have the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partner (via kick-out rights) without cause, **OR**

Step 2: The limited partners have "substantive participation rights."

Step 1:

The Task Force tentatively concluded that the determination of whether kick-out rights held by limited partners are substantive, should be made by analogy to the guidance in paragraph B20 of FIN 46(R). That is, to preclude consolidation by the general partner under Step 1, the limited partners must be able to dissolve (liquidate) the entity or remove the sole general partner by the vote of a simple majority of the interests held by parties other than the sole general partner.

For these rights to be substantive, the tentative conclusion requires that the limited partners, holding the kick-out rights, have the ability to exercise those rights if they chose to do so; that is, there are no significant barriers to the exercise of the rights. Barriers include, but are not limited to:

- Kick-out rights subject to conditions that make it unlikely they will be exercisable; for example, conditions that narrowly limit the timing of the exercise;
- Financial penalties or operational barriers associated with dissolving the limited partnership or replacing the sole general partner that would act as a significant disincentive for dissolution, or removal;
- The absence of an adequate number of qualified replacement sole general partners, or inadequate compensation to attract a qualified replacement;

5 For purposes of this Issue, a sole general partner is a single investor or an investor, and its related parties that own all of the general partnership interests in a limited partnership being considered for consolidation.

- The absence of an explicit, reasonable mechanism in the limited partnership agreement or in the applicable laws or regulations, by which the limited partners holding the rights can call for and conduct a vote to exercise those rights;
- The inability of the limited partners holding the rights to obtain the information necessary to exercise them.

Step 2:

The Task Force generally agreed that the limited-partner rights that would allow them to effectively participate in the following actions, should be considered substantive participating rights for this Issue:

1. Selecting, terminating, and setting the compensation of management responsible for implementing the limited partnership's policies and procedures;
2. Establishing operating and capital decisions of the limited partnership, including budgets, in the ordinary course of business.

However, the Task Force could not reach agreement on when the following rights would be substantive participating rights:

3. The sale or refinancing of limited partnership assets;
4. The acquisition of limited partnership assets.

Some Task Force members stated that the consolidation model for limited partnerships should be the same as for corporations within the scope of 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*; it provides that the minority shareholders' ability to block "acquisitions and dispositions of assets greater than 20 percent of the fair value of the investee's total assets" would be considered a protective right (i.e., does not preclude consolidation by the majority shareholder). However, AICPA Statement of Position (SOP) No. 78-9, *Accounting for Investments in Real Estate Ventures*, (for real estate partnerships) states that "if limited partners have **important rights**, such as the right to…approve the sale or refinancing of principal assets…, the partnership may not be under the control, directly or indirectly, of the general partnership interests." [Emphasis added]

The Task Force generally agreed that conditions 3 and 4 above should be refined. However, members were unable to conclude whether: (1) the important rights concept in SOP 78-9 should apply to all limited partnerships, (2) the consolidation model in Issue 96-16 should apply to corporations and all limited partnerships, or (3) SOP 78-9 accounting should continue to apply to real estate limited partnerships.

Further discussion of this Issue is expected.

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

This Issue was added to the agenda as part of a group of several issues identified by a mining industry Working Group. Although some Task Force members believe that the FASB 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 and only address stripping costs during 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), these costs, typically, are capitalized as part of the cost of the mine; and often are amortized over the productive life of the mine using the units of production method.

Once production begins, should ongoing stripping costs be expensed or capitalized? Conceptually, the production stripping costs benefit both current period production (because removal of the waste is necessary to extract the material mined in the current period), as well as future periods (since the costs facilitate access to additional minerals to be mined in the future).

At the September meeting, the Task Force generally supported an approach that stripping costs incurred during production are mine-development costs that should be capitalized as an investment in the mine. These capitalized costs should be attributed (i.e., expensed into the income statement) to proved and probable reserves in a systematic and rational manner. The Task Force further clarified that an enterprise would be expected to perform a detailed analysis of its particular facts and circumstances to support its method of attribution. Furthermore, an enterprise specifically must attribute stripping costs incurred during production

to reserves that directly benefit from the stripping activities. That is, if the reserves in the mine are distinct and stripping activities can be identified to benefit only a certain section of the mine or specific reserves, the enterprise would be required to attribute the capitalized stripping costs to the specific reserves benefited.

The Task Force did not make this a final consensus because they wanted to explore the impact of any consensus on mines with differing physical patterns of ore location (this affects the overall timing of attribution). In addition, the Task Force requested the guidance on attribution be articulated more precisely. A final consensus on this Issue is expected to be reached at the November meeting.

Further discussion of this Issue is expected.

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

This Issue was added to the agenda due to inconsistent methods used to identify whether certain derivatives or forward contracts are variable interests under FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*. FIN 46(R) provides that contracts that create variability in an entity are not variable interests and contracts that absorb variability of an entity are variable interests. However, a derivative or forward contract can be viewed as both creating and absorbing risks in a variable interest entity. The issue is how risks should be evaluated in determining whether the contract or instrument is absorbing variability, and thus, is a variable interest.

Three 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.

The Task Force generally did not support View C and was split on its preference for View A or View B as members believe that it is inappropriate to look at the same variability in multiple ways for the same entity.

The FASB staff believes that once an enterprise understands the total variability of a variable interest entity, the enterprise should understand which interests that absorb variability should be considered variable interests by considering qualitative and other factors. This has sometimes been referred to as the "by design" approach.

The Task Force generally did not support the "by design" approach as articulated in the Issue Summary because of its subjectivity based on the "intent" of investors. However, in an attempt to make progress on the Issue, the Task Force agreed to consider the following two-step process:

Step 1: Determine the predominant risk of the entity as either cash flow or fair value risk.

Step 2: Based on the predominant risk, holders of potential variable interests in the entity should consistently apply the fair value or cash flow approach.

As a result, the Task Force instructed the FASB staff to develop examples for further discussion at the November meeting.

Issue No. 04-8, *The Effects of Contingently Convertible Instruments on Diluted Earnings per Share*

Contingently convertible debt instruments, commonly referred to as Co-Cos, add a contingent feature to convertible debt. Co-Cos generally are 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 five consecutive 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 a potential for 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 usually 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 were (in practice) excluded from diluted EPS until the market price trigger is met based on the discussion in FASB Statement No. 128, *Earnings per Share*, on contingently issuable shares.

At the June/July 2004 meeting, 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 or whether the market price contingency is "substantive." Due to the broad potential impact, the tentative conclusion was posted for public comment.

At the September meeting, the Task Force considered this Issue, and comment letters received. After considering the alternative views, the Task Force affirmed its tentative consensus as it relates to **market price** contingencies. That is, a market price contingency should be ignored in calculating diluted EPS. The Task Force did not believe the economics of a Co-Co warranted different EPS treatment from conventional convertibles.

If ratified, this consensus would apply to convertible securities with a market price contingency, including:

- Contingently convertible debt,
- Contingently convertible preferred stock,
- Instrument C[6] as described in EITF Issue No. 90-19, *Convertible Bonds with Issuer Option to Settle for Cash Upon Conversion*, if "conversion" is predicated on a market price contingency similar to a Co-Co.

Example 1

On June 30, 2003, a Co-Co is 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 five consecutive days. During the quarter ended December 31, 2004, the average stock price of the underlying common stock was $95 per share.

The issuer should include the security in diluted EPS under the if-converted method (unless the result is anti-dilutive). Under the consensus, the fact that the market price contingency is not met is ignored for purposes of applying the if-converted method.

Example 2

Same facts as Example 1 except the principal must be settled in cash and the conversion spread is settled in stock.

The EPS guidance in Issue 90-19 should be followed. The issuer should NOT include the security in diluted EPS as of December 31, 2004, because the security is accounted for under the treasury stock method (that is, it is instrument C as described above). Since the conversion price is greater than the average market price during the period, there are no incremental shares that would be issued.

Example 3

Same facts as Example 2. During the quarter ended March 31, 2005, the average stock price of the underlying common stock was $105 per share.

The issuer would include the security in diluted EPS as of March 31, 2005, under the treasury stock method because the average market price of the security was in the money.

The consensus will be effective at the same time as the FASB's yet to be finalized international convergence standard, FASB Statement No. 128(R), *Earnings per Share* (expected to be effective for periods ending after December 15, 2004). Retroactive restatement of earnings per share is required unless:

- The entire agreement is settled in cash before the end of the effective reporting period in which the consensus is first applied, or
- The agreement is amended such that the entire contract must be settled in cash.

6 Instrument C is a security for which, upon conversion, the issuer must satisfy the accreted value of the obligation in cash and may satisfy the conversion spread (the excess conversion value over the accreted value) in either cash or stock. In accordance with paragraph 29 of Statement 128, and Issue 90-19, if the conversion spread is expected to be paid in stock, the treasury stock method is applied for the incremental shares to be issued in each period.

For agreements amended prior to the end of the reporting period in which the consensus is first applied, any EPS restatement should be based on the terms of the modified instrument.

Example 4

Consider the Co-Co that was issued in Example 1 above. Assume the issuer amends the agreement on December 10, 2004, such that the principal must be settled in cash and the conversion spread in stock (i.e., the instrument has been modified so that it is now Instrument C under Issue 90-19). The issuer must retroactively restate all prior periods using the treasury stock method as if the instrument had those terms since its initial issuance. For example, if the market price of the Company's stock had never reached the implied conversion price, the modification would not result in any restatement of previously issued diluted EPS.

No further discussion of this Issue is expected. However, the Task Force recommended that the Agenda Committee consider whether the EITF should address the expansion of this consensus in a related, but separate issue to: (1) contingently exercisable freestanding equity rights (e.g., a freestanding warrant that is exercisable only upon the occurrence of a market-price contingency), or (2) contingencies based on events other than the issuer's stock price.

Issue No. 04-9, *Accounting for Suspended Well Costs*

Paragraph 19 of FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, requires costs of drilling exploratory wells to be capitalized pending a determination of whether the well has found proved reserves. If the well has proved reserves, the capitalized costs become part of the entity's wells, equipment, and facilities; however, if the exploratory well has not found proved reserves, the capitalized costs of drilling the well are expensed, net of any salvage value.

Generally, Statement 19 imposes a one-year time limit, from the date of completion of the exploratory well, during which a company must conclude that proved reserves exist. Otherwise, unless specific criteria are met, the costs of the exploratory well are required to be written off.

Significant changes in oil and gas exploration have occurred since the FASB issued Statement 19 in 1977 that often make it unlikely the one-year timeline will be achieved. As a result, questions have arisen in practice about the relevance of the one-year time limit.

At the September meeting, the Task Force expressed support for exploratory well costs to be capitalized beyond one year under circumstances not specified in Statement 19. However, the Task Force removed this Issue from its agenda because its expressed support conflicts with explicit guidance in Statement 19. Instead, the Task Force recommended that the FASB issue a Board-directed FSP to amend Statement 19.

No further EITF discussion of this Issue is expected.

EITF Issue No. 04-10, *Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds*

This Issue is one of two that was added to the EITF agenda that deal with the aggregation of segments.[7] Issue 04-10 addresses the aggregation of segments that do not meet the quantitative thresholds under paragraph 18 of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*. If an operating segment does not meet one of the quantitative thresholds in paragraph 18, paragraph 19 permits an entity to combine information about that segment with other operating segments that do not meet the quantitative thresholds to produce a reportable segment only if the combined segments share a majority of the aggregation criteria listed in paragraph 17.

7 As described below in the Agenda Committee Report and Other Items, the second issue will not be considered by the Task Force. That Issue was added to the agenda to address the identification of the factors that must be considered and how they should be evaluated in the determination as to whether operating segments have similar economic characteristics.

Two diverse views exist regarding which paragraph 17 criteria should be included in a majority test.

View A	View B
Must have similar:	Be similar in a majority of:
• **Economic characteristics AND**	• **Economic characteristics**
Be similar in a majority of:	• Products and services
• Products and services	• Production processes
• Production processes	• Type of customer
• Type of customer	• Distribution methods
• Distribution methods	• Regulatory environment
• Regulatory environment	

At the September meeting, the Task Force reached a View A consensus. Operating segments that do not meet the quantitative thresholds can be aggregated to produce a reportable segment if:

1. Aggregation is consistent with the objective and basic principles of Statement 131,
2. The segments have similar economic characteristics, and
3. The segments share a majority of the other aggregation criteria listed in View A above.

This consensus may put significant pressure on the determination of whether operating segments have similar economic characteristics, which is discussed in the "Agenda Committee Report and Other Items" section below.

This consensus is effective no later than fiscal years ending after FASB Board ratification (expected to occur on October 13, 2004). The corresponding information for earlier periods, including interim periods, shall be restated unless it is impractical to do so.

No further discussion is expected.

SEC Staff Announcement on the Use of the Residual Method to Value Acquired Assets Other Than Goodwill (Topic D-108)

At the September meeting, the SEC staff provided guidance on the use of the so called "residual method" to value acquired intangible assets other than goodwill in a business combination.

The SEC concluded that the residual method does not comply with the requirements of FASB Statement No. 141, *Business Combinations*, and, accordingly, should no longer be used. Instead, a direct value method should be used to determine the fair value of all intangible assets required to be recognized under Statement 141. Similarly, impairment testing of intangible assets should not rely on a residual method, and should comply instead with the provisions of FASB Statement No. 142, *Goodwill and Other Intangible Assets*.

According to Topic D-108, the residual method should not be used in accounting for intangible assets (other than goodwill) acquired in business combinations completed after September 29, 2004. Further, companies that have applied the residual method to the valuation of intangible assets for purposes of impairment testing, will be required to perform an impairment test (no later than the beginning of their first fiscal year beginning after December 15, 2004) using a direct method. Reclassification of recorded balances between goodwill and intangible assets, prior to adoption of the staff announcement, is prohibited.

Agenda Committee Report and Other Items

Added Item — PCS Revenue of a Software Vendor in a Business Combination

This issue relates to the accounting in a business combination for deferred postcontract customer support (PCS) revenue of a "to be acquired" software vendor. Diversity in practice exists as to whether a customer's right to receive unspecified upgrades/enhancements on a "when-and-if-available" basis under a PCS arrangement should be reflected in the fair value of the legal performance obligation attributable to the PCS arrangement in a business combination.

This Issue will be discussed at a future EITF meeting.

Added Item — Stock-Based Compensation as a Participating Security

At the September meeting, the Task Force elected to add an Issue to its agenda related to whether stock-based compensation subject to the provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and FASB Statement No. 123, *Accounting for Stock-Based Compensation*, that contains a right to receive dividends declared on the common stock of the issuer is a participating security subject to the guidance in paragraphs 60 and 61 of FASB Statement No. 128, *Earnings per Share*.

This Issue is expected to be discussed at the November EITF meeting.

Removal of Issue No. 04-E, *The Meaning of Similar Economic Characteristics*

This topic deals with the second item discussed above in Issue 04-10. Paragraph 17 of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, requires an evaluation of similar economic characteristics to aggregate two or more operating segments into a single operating segment. In May 2004, this Issue was added to the agenda to address the identification of the factors that must be considered and how they should be evaluated in the determination as to whether operating segments have similar economic characteristics.

At the September meeting, the FASB staff recommended that the Task Force remove this Issue from the agenda because the staff believes there are not multiple views. The FASB staff indicated that they might issue an FSP in order to eliminate any diversity in practice that may exist. The Task Force agreed to remove the Issue from the agenda but expressed concern about the potential direction of an FSP that could change the way practice currently evaluates "similar economic characteristics."

FASB Issues FSP EITF Issue 03-1-1, *Effective Date of Paragraphs 10-20 of EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments"*

Although not an EITF action, this discussion relates to Issue 03-1. On September 30, 2004, the FASB issued FSP EITF Issue 03-1-1, delaying the effective date of paragraphs 10-20 of Issue 03-1. These paragraphs give guidance on how to evaluate and recognize an impairment loss that is other than temporary (i.e., steps 2 and 3 of Issue 03-1's impairment model). Application of those paragraphs is deferred pending issuance of proposed FSP EITF Issue 03-1-a. The guidance in paragraphs 6 through 9 of Issue 03-1 (i.e., step 1 of the impairment model), as well as the disclosure requirements in paragraphs 21 and 22, have not been deferred and should be applied based on the transition provisions in Issue 03-1.

This FSP and the proposed FSP (EITF Issue 03-1-a) are available on the FASB's Web site.

The Board emphasized that the deferral does not suspend other current accounting requirements covering impairment.

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