

EITF Roundup

Audit and Enterprise Risk Services

November 2006

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D-Topics

Next EITF Meeting

by Richard Starzecki and Brian Maloney, Deloitte & Touche LLP

This issue of EITF Roundup covers the November 16, 2006, meeting of the Emerging Issues Task Force ("EITF" or "Task Force").

At its November 29, 2006, meeting, the Financial Accounting Standards Board ("FASB" or "Board") ratified the consensuses and tentative conclusions reached at the November EITF meeting. The Board also approved exposure of the tentative conclusions for a comment period beginning on or after December 5, 2006, and ending on January 15, 2007. At the next scheduled EITF meeting (March 14 and 15, 2007), the Task Force will consider comments received, and, as warranted, affirm its tentative conclusions as consensuses. Consensuses will then be provided to the Board for ratification.

Official EITF minutes and EITF meeting materials are posted to Technical Library: The Deloitte Accounting Research Tool and to the FASB's Web site.

The Task Force discussed the following topics:

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 three 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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Issue No. 06-6, “Debtor’s Accounting for a Modification (or Exchange) of Convertible Debt Instruments”

- STATUS:** Consensus Reached. The consensus amends Issue No. 96-19 and supersedes Issue No. 05-7.
- AFFECTS:** Issuers that modify the terms of (or that exchange) convertible debt instruments that contain an embedded conversion option not accounted for as a derivative under FASB Statement No. 133, *Accounting for Derivate Instruments and Hedging Activities*.
- EFFECTIVE:** Applies to modifications (or exchanges) occurring in interim or annual reporting periods beginning after November 29, 2006. Early application is permitted for modifications (or exchanges) occurring in periods for which financial statements have not been issued.
- TRANSITION:** Apply prospectively. Retrospective application to prior year financial statements is **not** permitted.

Issue No. 96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments,” provides guidance in determining whether the modification (or exchange) of a debt instrument results in a new debt instrument that is considered “substantially different” from the original. If so, the modification (or exchange) is treated as an extinguishment of the original debt, typically accompanied by a gain or loss. If the present value of the new instrument’s cash flows differs by at least 10 percent from that of the original (the “cash flow test”), the debt instruments are considered substantially different — and extinguishment accounting is required.

Issue No. 05-7, “Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues,” expanded the cash flow test to capture — as a cash flow — the fair value change of an embedded conversion option resulting from a modification (or exchange). However, upon implementation, it became evident that the expanded test missed the mark. That is, in most modifications or exchanges, the lender and borrower exchange equal value. Accordingly, the change in the conversion option’s fair value is offset by the consideration paid or received to affect the change, and substantially different instruments are not identified as such.

To address this offsetting effect, the Task Force affirmed its tentative conclusion, reaching a consensus that the change in fair value of a conversion option associated with a modification (or exchange) should not be included in the cash flow test.

However, if the cash flow test does not result in an extinguishment, a second test is required. Under the second test, the issuer compares the change in fair value of the embedded conversion option — calculated as the difference between the conversion option’s fair value immediately before and after the modification (or exchange) — to the carrying amount of the original debt instrument immediately before the modification (or exchange). If the change in fair value is at least 10 percent of the carrying amount of the original debt, the instruments are considered substantially different, resulting in extinguishment accounting.

Finally, any modification (or exchange) that adds or eliminates a “substantive” conversion option (with “substantive” contemplated in the context of Issue No. 05-1, “Accounting for the Conversion of an Instrument That Becomes Convertible Upon the Issuer’s Exercise of a Call Option”) also results in substantially different instruments.

Consider the following example of an in-scope modification:

Company Z (Z) has \$10 million of five-year convertible notes outstanding. The notes are convertible into 500,000 shares of Z’s common stock — a \$20 per share conversion price. The notes do not contain a beneficial conversion feature, and the conversion option does not require separate accounting under Statement 133.

One year after issuance, Z is having difficulty meeting certain of its debt covenants. As a solution, Z and the note holders agree to modify the terms of the debt instrument such that certain debt covenants are eliminated in exchange for a reduction in the price of the conversion option (down to \$17 per share). The fair value of the conversion option was \$1 million immediately before the modification and \$2.1 million after. No cash is exchanged as part of the modification.

In determining whether the above modification results in substantially different debt instruments, Z evaluates the three conditions (or tests) in Issue 96-19, as amended by Issue 06-6.

First is the cash flow test. Because the modification did not change the cash flows of the original debt instrument, Z “passes” the cash flow test (i.e., no extinguishment). In the second test, Z assesses the change in the conversion option’s fair value as a result of the modification. The \$1.1 million change in fair value represents 11 percent of the original debt amount immediately before modification. As this change is “at least 10 percent,” the modified debt instrument is considered substantially different from the original and extinguishment accounting is required. The third test — whether the modification added or eliminated a substantive conversion option — is not applicable in this example.

The Task Force also concluded that if, after applying the three tests described above, a modification (or exchange) does not result in an extinguishment, an increase in the conversion option’s fair value should be recognized as a reduction to the carrying amount of the debt, with a corresponding increase to additional paid-in capital. A decrease in the fair value of the conversion option should **not** be recognized.

Issue No. 06-7, “Issuer’s Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities”

STATUS:	Consensus Reached
AFFECTS:	Convertible debt issuers with previously bifurcated conversion options that no longer require separate derivative accounting under Statement 133.
EFFECTIVE:	Interim and annual periods beginning after December 15, 2006. Early application is permitted for periods in which financial statements have not been issued. Retrospective application is permitted.
TRANSITION:	Apply prospectively to all previously bifurcated conversion options that no longer require bifurcation.

If a convertible debt instrument’s embedded conversion option fails to satisfy the criteria in paragraph 12 of Statement 133, the conversion option requires bifurcation from the debt instrument (and recognition as a derivative liability). Frequently, share settlement restrictions, such as an insufficient amount of authorized and unissued shares to share settle all existing commitments, result in bifurcation of a conversion option (see Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”). However, if the criteria that resulted in bifurcation are later satisfied (e.g., sufficient shares are now available to effect share settlement), derivative accounting no longer applies. At issue is how to account for the removal of the derivative liability.

The Task Force affirmed its tentative conclusion, reaching a consensus that when a conversion option no longer requires separate accounting, the derivative liability should be reclassified to shareholders’ equity. Any debt discount should continue to be amortized over the remaining term of the debt. As a result, the effective interest rate on the debt instrument will continue to exceed its coupon rate.

Although it did not discuss these topics at its September meeting, the Task Force also reached a consensus that:

- When a holder exercises a previously bifurcated conversion option, any remaining unamortized debt discount shall be recognized immediately as interest expense. This approach is consistent with that of settling an instrument with the characteristics of “Instrument C” in Issue No. 03-7, “Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue No. 90-19).”
- When a debt instrument with a previously bifurcated conversion option is extinguished for cash (or other assets) prior to its stated maturity, the reacquisition price should first be charged to shareholders’ equity based on the conversion option’s fair value on the extinguishment date. Any residual should then be allocated to the debt extinguishment in determining the amount of gain or loss.

Finally, the Task Force reached a consensus that when a previously bifurcated conversion option no longer requires separate accounting, the issuer shall disclose (1) a description of the change causing the conversion option to no longer require bifurcation and (2) the amount of the derivative liability reclassified to shareholders’ equity.

Consider the following example (amounts rounded for illustrative purposes):

Company X (X) issues \$10 million of convertible notes at par, which are convertible into 1 million common shares. Company X has 50 million shares authorized and 45 million shares issued and outstanding. In addition, X has 4.5 million shares of vested stock options outstanding. The stock options and convertible debt represent the only potential share commitments.

At issuance, X's issued and outstanding shares, plus its existing share commitments, exceed its 50 million of authorized shares; share settlement of the debt is not within X's control. Therefore, the conversion option must be bifurcated from the debt instrument and accounted for as a derivative liability. The fair value of the conversion option at issuance is \$1 million.

One year after issuance, X's Board authorizes 10 million of additional shares, bringing total authorized shares to 60 million. The fair value of the conversion option has increased to \$2 million. There have been no changes in X's vested stock options, and no additional potential share commitments. As share settlement is now within X's control, the conversion option no longer requires bifurcation.

Three years after issuance, X extinguishes the debt for \$11 million. The fair value of the previously bifurcated conversion option is \$500,000, at that time and the remaining unamortized debt discount is \$400,000.

In the example above, a \$1 million derivative liability (with an offsetting debt discount) is recorded at issuance. The derivative liability is then carried at fair value. On the date the authorized shares are sufficient to share settle the option, the then \$2 million derivative liability is reclassified to shareholders' equity. Company X continues to amortize the debt discount over the remaining term of the debt instrument.

In recording the extinguishment, X would charge the then fair value of the conversion option (\$500,000) to shareholders' equity and recognize a loss on extinguishment of \$900,000 (\$11 million paid less the (1) \$500,000 charged to shareholders' equity and (2) \$9.6 million carrying amount of the debt).

Issue No. 06-8, "Application of the Assessment of a Buyer's Continuing Investment Under FASB Statement No. 66, Sales of Real Estate, for Sales of Condominiums"

STATUS:	Consensus Reached
AFFECTS:	Condominium developers.
EFFECTIVE:	First annual reporting period beginning after March 15, 2007. Earlier application is permitted as of the beginning of a fiscal year.
TRANSITION:	Apply as a change in accounting principle through a cumulative-effect adjustment at the beginning of the year of adoption.

Condominium developers often sell individual condominium units in advance of completing the entire project, with the buyer making a down payment at the time of contract signing. In accounting for such sales, developers apply either the percentage-of-completion method — provided the criteria listed in paragraph 37 of Statement 66 are met — or the deposit method. One criterion in paragraph 37 requires that the sale price be deemed **collectible** and references paragraph 4 of Statement 66 in assessing collectibility. Paragraph 4, in turn, assesses collectibility through, among other considerations, demonstration of the buyer's "substantial initial and continuing investments that give the buyer a stake in the property sufficient that the risk of loss through default motivates the buyer to honor its obligation to the seller." At issue is whether (and how) an entity should assess a buyer's **continuing investment** for condominium unit sales during the period before the buyer and developer close the sale.

The Task Force affirmed its tentative conclusion, reaching a consensus that an entity should evaluate the adequacy of the buyer's continuing investment, pursuant to paragraph 12 of Statement 66, in determining whether to recognize profit under the percentage-of-completion method. Although it did not discuss these topics at its September meeting, the Task Force also reached a consensus that (1) the buyer's initial and continuing investment tests should only consider nonrefundable amounts, and (2) when an entity reassesses the criteria in paragraph 37 of Statement 66, the buyer's initial and continuing investment tests should be applied prospectively on a reassessment date (i.e., as though the reassessment date were the initial contract date).

An entity can meet the continuing investment test by requiring the buyer to either (1) make additional payments during the construction term at least equal to the level **annual** payment to fund principle and interest on a customary amortizing mortgage for the remaining purchase price of the property or (2) increase the minimum initial investment, as defined in Statement 66, by an equivalent aggregate amount. In performing this assessment, the remaining purchase price should be determined based on the sales price of the property. If the buyer's initial or **continuing** investment is not sufficient, the developer should apply the deposit method.

Consider the following example:

Condominium developer (D) entered into two separate contracts for the purchase of individual condominium units. Contract A was entered into with three years remaining until completion; Contract B was entered into with two years remaining. The purchase price was the same for both units, as were the deposits.

For Contract A, the deposit was sufficient to cover the initial investment test under Statement 66, but the continuing investment test was not satisfied. The excess deposit (beyond that needed to cover the minimum initial investment) was not sufficient to cover the level annual principle and interest payments on a customary mortgage over the three-year construction period.

For Contract B, the deposit was sufficient to cover both the initial and continuing investment tests.

Assuming all other criteria of paragraph 37 of Statement 66 (and paragraph 4 assessments) are met, when can D begin to apply the percentage-of-completion method to the respective deposits?

Contract B qualifies for the percentage-of-completion method at the contract date. For Contract A, the down payment would initially be classified as a deposit (in accordance with Statement 66), and D would reassess collectibility at each reporting period thereafter. All else being equal, Contract A will qualify for the percentage-of-completion method when two years remain until project completion, because on that date the deposit is sufficient to cover the initial **and** continuing investment tests. As a result, Contracts A and B are afforded similar accounting treatment at similar points in time.

Issue No. 06-9, "Reporting a Change in (or Elimination of) a Previously Existing Difference Between the Fiscal Year-End of a Parent Company and That of a Consolidated Entity or Between the Reporting Period of an Investor and That of an Equity Method Investee"

STATUS:	Consensus Reached
AFFECTS:	Entities that change, or eliminate, differences in a reporting period between a parent company and a consolidated entity or between an investor and an equity method investee. Issue 06-9 does not apply in situations where a parent company (or investor) changes its fiscal year-end.
EFFECTIVE:	Changes occurring in interim or annual reporting periods beginning after November 29, 2006. Early application is permitted for periods in which financial statements have not been issued.
TRANSITION:	Apply as a change in accounting principle through retrospective application in accordance with FASB Statement No. 154, <i>Accounting Changes and Error Corrections</i> .

Diversity in practice exists on how to recognize a change in a consolidated subsidiary's or equity method investee's reporting period. Prior to Statement 154, these changes, regardless of their characterization, were typically recorded as a cumulative-effect adjustment to opening retained earnings in the year of change. However, if the change is considered a change in accounting principle, Statement 154 requires retrospective application to all prior-period financial statements presented.

The Task Force affirmed its tentative conclusion, reaching a consensus that a change in a subsidiary's or equity method investee's reporting period is a change in accounting principle. Therefore, the parent or investor should recognize the effects of the change through retrospective application to all prior periods presented pursuant to Statement 154.

Consider the following example:

Parent Company P (P) has a fiscal year-end of December 31. Company P's consolidated subsidiary, S (S), has a fiscal year-end of September 30 and is consolidated by P based on S's fiscal year-end (creating a three-month reporting period lag). Company P wishes to eliminate the lag period and conform S's year-end with its own.

In the example above, assume P presents two years of balance sheets and three years of statements of operations and shareholders' equity on a consolidated basis. P would adjust its opening retained earnings for the earliest year presented and retrospectively present the prior year's balance sheet, and prior years' statements of operations and shareholders' equity as though S's fiscal year-end had always been December 31.

In accordance with Statement 154, P must justify the change as preferable.

Issue No. 06-10, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements"

STATUS:	Tentative Conclusion Reached
AFFECTS:	Entities, including many privately-owned companies not subject to the Sarbanes-Oxley Act of 2002, who participate in collateral assignment split-dollar life insurance arrangements that provide an employee benefit extending into an employee's retirement period.
EFFECTIVE:	Would be effective for fiscal years beginning after December 15, 2007, with earlier application permitted.
TRANSITION:	Would recognize the effects of a consensus as a change in accounting principle through either (1) a cumulative-effect adjustment or (2) retrospective application to all prior periods.
NEXT STEPS:	The tentative conclusion will be exposed for a comment period beginning on or after December 5, 2006.

Issue 06-10 is a follow-up issue to Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements." The consensus reached in Issue 06-4 is that an employer should recognize a liability for future benefits associated with an **endorsement** split-dollar life insurance arrangement in accordance with FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, or APB Opinion No. 12, *Omnibus Opinion — 1967*, based on the substantive nature of the agreement with the employee. At issue is whether this consensus should be applied to collateral assignment split-dollar arrangements.

The key difference between an endorsement and a collateral assignment split-dollar arrangement is who owns and controls the underlying life insurance policy — the employer (endorsement) or employee (collateral assignment).

Consider the following example of a typical collateral assignment split-dollar arrangement:

On January 1, 20X6, Company X (X) purchases a \$10 million life insurance policy on behalf of its CEO, making a one-time premium payment of \$1 million at policy inception. Company X transfers ownership and control of the policy to the CEO, and the CEO names a beneficiary.

Under the terms of the arrangement (and in return for the premiums paid), the CEO irrevocably assigns a portion of the policy's death benefit as collateral for X's interest in the policy (i.e., the collateral assignment). While the amounts paid to X upon the CEO's death may vary, X's collateralized interest in the policy death benefit is at least equal to the \$1 million of premiums paid on behalf of the CEO.

The CEO is expected to retire in 10 years and is contractually restricted from surrendering the policy at any time, including during retirement. Actuarial mortality tables indicate that the CEO is expected to live for 20 years after retirement.

Because employees own and control these policies, employers have historically recorded their interests in collateral assignment split-dollar arrangements as employee receivables, generally recognized at discounted amounts in accordance with APB Opinion No. 21, *Interest on Receivables and Payables*. As the arrangements are considered tantamount to employee loans, postretirement benefit obligations generally have **not** been recognized.

The Task Force reached a tentative conclusion that an employer should recognize a liability for the postretirement benefit related to a collateral assignment split-dollar arrangement, in accordance with Statement 106 (if deemed part of a postretirement plan) or Opinion 12 (if not part of a plan). The postretirement benefit should be determined (and measured) based on the substantive agreement with the employee. The Task Force concluded that an employer remains subject to the risk and rewards associated with the underlying insurance contract that collateralizes the employer's interest. In addition, an employer's continuing interest in the underlying insurance contract precludes a "settlement" pursuant to Statement 106.

Regarding asset recognition, the Task Force reached a tentative conclusion that the employer should recognize and measure an asset based on the nature and substance of the collateral assignment arrangement. For instance, an arrangement may represent an interest-free loan to the employee (albeit with continuing risk to the employer) equal to a one-time premium payment made on behalf of the employee. In such instances, an asset would be recognized and measured as a receivable and discounted in accordance with Opinion 12. Other arrangements may entitle the employer to recover its premiums paid plus a variable return, measured as the cash surrender value of the policy at the employee's date of death. In those instances, an asset would be recognized and measured at an amount equal to the policy's cash surrender value. The FASB staff indicated that examples may be forthcoming.

Issue No. 06-11, "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards"

STATUS:	Tentative Conclusion Reached
AFFECTS:	Entities that pay dividends (or dividend equivalents) on employee-held equity-classified nonvested shares, nonvested share units, or outstanding share options (together "affected securities").
EFFECTIVE:	Would be effective for annual reporting periods beginning after September 15, 2007. Early application would be permitted for income tax benefits associated with dividends (or dividend equivalents) paid in periods for which financial statements have not been issued.
TRANSITION:	Would apply prospectively to income tax benefits associated with dividends (or dividend equivalents) paid on affected securities. Retrospective application would be prohibited.
NEXT STEPS:	The tentative conclusion will be exposed for a comment period beginning on or after December 5, 2006.

Entities may pay dividends (or dividend equivalents) to employees holding affected securities. Compensation expense associated with a share-based award is recorded over the requisite service period, generally resulting in a corresponding deferred tax asset. At issue is how a **realized** tax benefit associated with dividends (or dividend equivalents) that are (1) paid to employees holding affected securities and (2) charged to retained earnings under FASB Statement No. 123(R), *Share-Based Payment*, should be recognized.

The Task Force reached a tentative conclusion that an entity should recognize, as an increase to additional paid-in capital, a realized tax benefit related to in-scope dividends (or dividend equivalents). Amounts recognized should be included in the pool of excess tax benefits available to absorb potential future tax deficiencies on share-based payment awards (i.e., the "APIC pool").

However, to the extent a tax benefit is **not** realized at the time the dividends (or dividend equivalents) are paid (e.g., situations in which an entity has a net operating loss carryforward), the income tax benefit should not be recognized until the deduction reduces taxes payable (i.e., until the tax benefit is realized). Unrealized amounts are not included in the APIC pool.

Consider the following example:

Company A (A) has an employee stock option plan that provides dividend participation for outstanding, vested awards. On January 1, 20X8, A declares, and pays, a \$.25 dividend to its shareholders. Company A's dividend to its vested option holders totals \$1 million.

A's effective tax rate is 40 percent and its current tax payable is \$1 million at the time of the dividend payment.

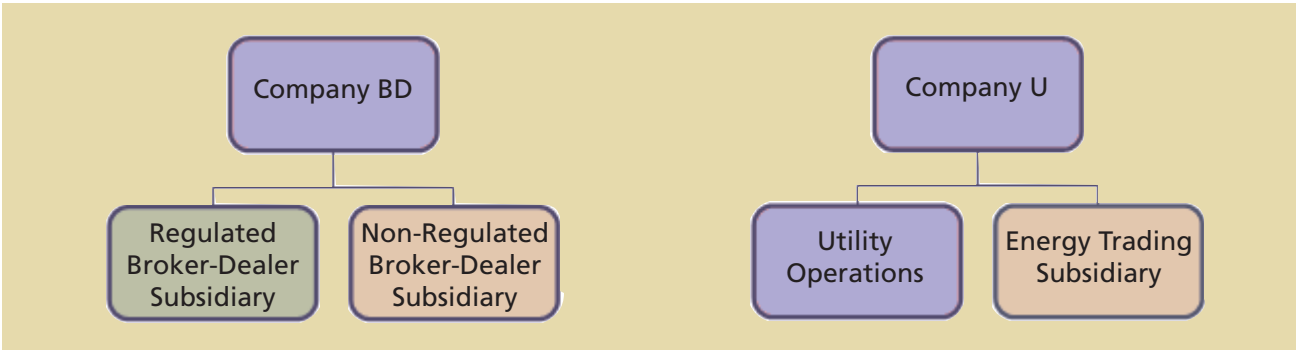
In the above example, A would record a \$400,000 reduction to its current tax payable, with a corresponding increase to additional paid-in capital, for the realized tax benefit associated with the dividends paid on the vested options (\$1 million of dividends paid at its 40 percent tax rate). The increase to additional paid-in capital **would** be considered part of A's APIC pool.

Issue No. 06-12, "Application of AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*, to Entities That Engage in Commodity Trading Activities and Related Issues"

- STATUS: No Decision Reached
- AFFECTS: Registered and non-registered broker-dealers, as well as other entities that conduct business activities consistent with those of a broker-dealer.
- NEXT STEPS: The Task Force made an agenda request to the Board to add a project addressing whether traded, physical commodity inventory should be carried at fair value. The FASB staff will continue its research regarding application of the Guide and report back to the Task Force at the March 2007 EITF Meeting.

Questions have been raised as to which types of entities may apply the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities* (the "Guide"). The Guide's preface narrowly describes a broker-dealer as an entity registered as a broker-dealer under the Securities Exchange Act of 1934 or under comparable foreign regulations.

Consider the following example:



Company BD (BD) is a broker-dealer with a regulated and non-regulated broker-dealer subsidiary, both of which participate in activities consistent with those of a broker-dealer.

Company U (U) is a utility company that has both an operating and an energy trading subsidiary. The energy trading subsidiary participates in activities consistent with those of a broker-dealer.

At issue is whether BD's non-regulated subsidiary, and U's energy trading subsidiary, may apply the Guide.

In the above example, the regulated broker-dealer subsidiary is, by definition, included in the scope of the Guide.

However, diversity in practice exists as to the Guide's application to the non-regulated subsidiary, and while the activities of Company U's energy trading subsidiary are similar to those of a broker-dealer, the Guide is not applied.

In addition, diversity exists with respect to interpreting whether entities within the scope of the Guide should carry physical commodity inventory held for trading at fair value. The Guide does provide for inventory and derivatives to be carried at fair value. At issue is whether physical commodities are inventory as contemplated in the Guide or inventory that should be accounted for in accordance with Accounting Research Bulletin No. 43, Chapter 4, "Inventory Planning" (i.e., at cost, less any impairment).

At the November meeting, the Task Force discussed varying views on the above issues without reaching any tentative conclusions. See "Next Steps" above.

D-Topics

The Securities and Exchange Commission staff informed the Task Force of editorial changes to Topic No. D-36, "Selection of Discount Rates Used for Measuring Defined Benefit Pension Obligations and Obligations of Postretirement Benefit Plans Other Than Pensions," to conform the abstract to FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*.

Next EITF Meeting

The next EITF meeting is scheduled for March 14 and 15, 2007. Deloitte & Touche will host a Dbriefs webcast on March 20, 2007, covering the topics discussed at the meeting. [Join Dbriefs](#) to be notified of this and other upcoming webcasts.

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