

# EITF Roundup

Audit and Enterprise Risk Services

June 2005

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by Gordon McDonald, Deloitte & Touche LLP

This issue of *EITF Roundup* introduces *EITF Flash*, beginning on the next page. *EITF Flash* enables readers to identify easily topics relevant to their needs and to understand the status of each topic as of the end of the EITF meeting.

*EITF Roundup* covers the June 15–16, 2005, meeting of the Emerging Issues Task Force (EITF or the "Task Force"). EITF consensuses are not final until ratified by the Financial Accounting Standards Board (FASB). Official EITF minutes are posted to the [Deloitte Accounting Research Tool \(DART\) Web site](#). EITF meeting materials distributed to the Task Force prior to the meeting and final meeting minutes are available on the [FASB's Web site](#).

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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## EITF Flash

As discussed at the June 15–16, 2005, meeting of the Emerging Issues Task Force.

### **Issue No. 04-5, “Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights**

STATUS: Final Consensus Reached

IMPACT: All companies that serve as a general partner in limited partnerships, especially real estate and investment limited partnerships, and managing members of limited liability companies governed like partnerships. The consensus does not apply if the partnership or similar entity is a variable interest entity (VIE) accounted for under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*.

SUMMARY: A general partner of a limited partnership is presumed to control the limited partnership; unless the limited partners have substantive kick-out rights or participating rights. FASB is expected to conform AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*.

EFFECTIVE: Upon ratification for new limited partnership agreements and for pre-existing limited partnership agreements that are modified; otherwise, effective for fiscal years beginning after December 15, 2005.

NEXT STEPS: FASB ratification expected in June.

### **Issue No. 04-13, “Accounting for Purchases and Sales of Inventory With the Same Counterparty”**

STATUS: Tentative Conclusion Reached

IMPACT: Companies that buy and sell (or exchange) inventories with the same counterparty.

SUMMARY: Inventory purchase and sales transactions with the same counterparty that are entered into in contemplation of one another should be combined and treated as a nonmonetary exchange involving inventory.

Nonmonetary exchanges of finished goods for raw material and finished goods for work-in-process in the same line of business should be recorded at fair value. All other inventory-for-inventory exchange transactions do not culminate the earnings process.

EFFECTIVE: Transactions completed in reporting periods beginning after March 15, 2005.

NEXT STEPS: The Task Force recommended that a draft abstract of this tentative conclusion be posted for public comment prior to the September 2005 meeting. Further discussion of this Issue is expected.

### **Issue No. 05-1, “Accounting for the Conversion of an Instrument That Becomes Convertible Upon the Issuer’s Exercise of a Call Option”**

STATUS: Tentative Conclusion Reached

IMPACT: Issuers of contingently convertible debt instruments and certain other instruments that can become convertible upon the exercise of a call option.

SUMMARY: Applies to instruments that would not have been convertible except for the issuer’s exercise of a call option. The carrying amount of the debt should be reclassified to equity and no gain or loss should be recognized.

EFFECTIVE: Not yet discussed.

NEXT STEPS: Task Force is considering an alternative model, wherein, if the shares underlying the instrument previously were included in the denominator in diluted EPS, the instrument becoming convertible upon the issuer’s exercise of a call option would have no effect on income. However, if the shares underlying the instrument had not been included previously in diluted EPS, exercise of the call and any resulting conversion would result in an extinguishment loss. Further discussion is expected.

### **Issue No. 05-2, “The Meaning of ‘Conventional Convertible Debt Instrument’ in EITF Issue No. 00-19, ‘Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock’”**

STATUS: Final Consensus Reached

IMPACT: Entities issuing non-vanilla convertible debt or convertible preferred stock with a mandatory redemption date.

SUMMARY: Instruments that provide the holder with an option to convert into a fixed number of shares, and the ability to exercise that option is based on the passage of time or a contingent event, should be considered “conventional.” This includes mandatorily redeemable convertible preferred debt that is more akin to debt

than equity. The consensus does not affect current accounting for contingently convertible instruments (CoCos), as would have other possibilities considered by the Task Force.

EFFECTIVE: Upon FASB ratification.

NEXT STEPS: FASB ratification expected in June.

### **Issue No. 05-3, "Accounting for Rental Costs Incurred During the Construction Period"**

STATUS: Failed to reach a consensus and issue removed from EITF agenda

IMPACT: Entities incurring rental costs associated with ground and building leases during the construction of an asset that is directly related to the leased property.

SUMMARY: Currently, diversity in practice exists; some entities capitalize rental costs that are incurred during the construction period while others expense the rental costs.

EFFECTIVE: N/A

NEXT STEPS: FASB to consider issuing a FSP. The FSP may conclude that rental costs should be expensed during the construction period.

### **Issue No. 05-4, "The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to EITF Issue No. 00-19, 'Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock'"**

STATUS: No Decisions Reached

IMPACT: Entities issuing instruments (e.g., stock warrants) that are settled in the issuer's own shares accompanied by a registration rights agreement with a liquidated damages clause. The agreement calls for cash payments if the issuer, within a certain grace period, fails to have the registration of the underlying shares declared effective.

SUMMARY: The Task Force was unable to make progress on the issue, partly because differing views were expressed on whether the liquidated damages clause is a separate instrument, and, when analyzed on a stand-alone basis, whether the clause meets the definition of a derivative instrument.

EFFECTIVE: N/A

NEXT STEPS: The Task Force asked the staff to prepare an analysis on whether the registration rights agreements is a derivative under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

### **Issue No. 05-5, "Accounting for the Altersteilzeit Early Retirement Programs"**

STATUS: Final Consensus Reached

IMPACT: U.S. companies with German subsidiaries or non-U.S. companies that provide benefit arrangements for employees under an Altersteilzeit (ATZ) Early Retirement Program or an arrangement with the same terms.

SUMMARY: Salary payments should be recognized ratably over the portion of the ATZ period when the employee is providing active services (the "active service period").

Accruals for the termination benefit under Type II should be accrued ratably from the date the employee signs the ATZ contract to the end of the active service period.

Recognize the government subsidy when the criteria to receive it have been met.

EFFECTIVE: Fiscal years beginning after December 15, 2005.

NEXT STEPS: FASB ratification expected in June.

### **Issue No. 05-6, "Determining the Amortization Period for Leasehold Improvements"**

STATUS: Final Consensus Reached

IMPACT: Entities acquiring leasehold improvements in a business combination and all other entities that incur significant leasehold improvements whose useful life extend beyond the *term* of the lease.

SUMMARY: Leasehold improvements acquired in a business combination should be amortized over the lesser of the useful life of the assets or a term that includes renewals that are *reasonably assured* at the date of acquisition.

Leasehold improvements purchased significantly after, and not contemplated at the beginning of the lease term, should be amortized over the lesser of the useful life of the assets or a term that includes renewals that are *reasonably assured* at the date the leasehold improvements are purchased.

EFFECTIVE: Upon FASB ratification.

NEXT STEPS: FASB ratification expected in June.

## Detailed Discussion

As discussed at the June 15–16, 2005, meeting of the Emerging Issues Task Force.

### Issue No. 04-5, “Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights”

STATUS: Final Consensus Reached

IMPACT: All companies that serve as a general partner in limited partnerships, especially real estate and investment limited partnerships, and managing members of limited liability companies governed like partnerships. The consensus does not apply if the partnership or similar entity is a variable interest entity (VIE) accounted for under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*.

NEXT STEPS: FASB ratification expected in June.

At the June meeting, the Task Force finalized, with minor modifications, its previous tentative consensus. A general partner (GP) (or a group of GPs) of a limited partnership **is presumed to control the limited partnership**, unless either:

1. The limited partners (LPs) have the substantive ability to dissolve<sup>1</sup> (liquidate) the limited partnership or otherwise remove the GP (kick-out rights) without cause, or
2. The LPs have “substantive participating rights.”

The Task Force believes the presumption of control by the GP(s) is appropriate because the consolidation-based-on-control model under GAAP typically requires a company, which controls the resources of another entity, to consolidate that entity — even if the parent’s economic interest is small. Thus, the nature of a limited partnership is such that the GP appears to control it, absent circumstances that indicate otherwise.

#### Example 1

A limited partnership (a non-VIE) is established by three LPs (each owning 33 percent) and a one percent GP. The GP manages the partnership and makes all decisions. The LPs do not have the substantive ability to dissolve (liquidate) the limited partnership nor to remove the GP. In addition, the LPs have no rights to participate in the decisions or initiate actions of the limited partnership.

The GP would not overcome the presumption of control because the LPs do not have either of the rights required by Issue 04-5. Therefore, the GP should include in its consolidated financial statements the assets, liabilities, and revenues and expenses of the limited partnership. The LPs’ rights to the profits and losses of the partnership would be recorded as minority interest in the consolidated statements of the GP in accordance with Accounting Research Bulletin No. 51, *Consolidated Financial Statements*.

#### 1. Substantive Kick-Out Rights

The Task Force discussed a suggestion that would permit an entity to conclude that kick-out rights are substantive if the limited partnership agreement requires a super-majority vote to remove the GP and a super-majority of the LP interests were held by **one** LP. The Task Force concluded in this situation that the LP kick-out rights are substantive in spite of the agreement’s super majority requirement, and, thus, overcomes the presumption of control by the GP. In assessing whether a single LP has the ability to remove the GP, consideration must be given to LPs that are under common control, are related parties, or are required to act in concert with one another in exercising the kick-out rights. Also, the Task Force concluded that a GP must reassess the LPs’ rights and the impact of the rights on the presumption of control of the limited partnership for each reporting period.

<sup>1</sup> The limited partners’ unilateral right to withdraw from the partnership in whole or in part (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership would not overcome the presumption that general partners control the limited partnership (that is, the withdrawal right is not deemed to be a kick-out right).

## Example 2

On January 1, 20X6, a limited partnership (a non-VIE) is established with a sole LP owning a 95 percent interest and a five percent GP. The GP manages the limited partnership. The limited partnership agreement requires a 66 2/3 percent majority vote of the LPs to remove, without cause, the GP. The LP has no rights to participate in the decisions or initiate actions of the limited partnership. On July 1, 20X6, the LP sells a 60 percent interest in the limited partnership to two unrelated LPs (30 percent each).

The GP can overcome the presumption of control from January 1, 20X6, to June 30, 20X6, because the sole LP has the unilateral ability to remove the GP during that period, irrespective of the voting percentage contractually required to remove the GP.

However, for periods beginning after June 30, 20X6, the GP cannot overcome the presumption of control. The LPs do not have either of the rights required by Issue 04-5. The LPs have kick-out rights; however, the right is not substantive because greater than a simple majority vote of the LPs is required to remove the GP and no single LP has the unilateral ability to remove the GP.

If the final consensus is ratified by the FASB (expected at the FASB's June 29 meeting), Issue 04-5 will be effective immediately following ratification for all **new** limited partnership agreements and for pre-existing limited partnership agreements that are **modified**.

For pre-existing limited-partnership agreements that are not modified, Issue 04-5 would be effective in fiscal years beginning after December 15, 2005. Preparers can choose one of the following two methods for transition:

- Method A — Record the cumulative effect, if any, at the beginning of the period in which Issue 04-5 is first applied. The financial statements for prior years should be presented as previously reported, and the cumulative effect, if any, should be **included in opening retained earnings** of the period of the change and **not in the net income** of the period of change.
- Method B — Restate prior period financial statements.

A GP also overcomes the presumption of consolidation if the LPs have *preventive rights* (but not *protective rights*) as defined in EITF Issue No. 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights." In connection with these rights, the Task Force made conforming changes to Issue 96-16 (which deals with corporate entities rather than limited partnerships). Before the change, the ability of minority shareholders to block acquisitions and dispositions of assets greater than 20 percent of the fair value of the total assets was considered to be a protective right that would not overcome the presumption of consolidation by the investor with the majority voting interest. As changed, Issue 96-16 will define a protective right as one in which minority shareholders are able to block asset acquisitions only in instances that are **not** expected to occur in the **ordinary** course of business. The amendment to Issue 96-16 will be effective upon ratification by the Board (expected at the FASB's June 29 meeting).

**Note:** The FASB has proposed changes to AICPA Statement of Position (SOP) 78-9, *Accounting for Investments in Real Estate Ventures*, for issuance in an FSP. The FSP will conform SOP 78-9 to Issue 04-5 concerning the rights of LPs that preclude consolidation by a GP. The FSP will be discussed by the FASB Board at its June 29 meeting in conjunction with the ratification of the consensus in Issue 04-5.

## Issue No. 04-13, "Accounting for Purchases and Sales of Inventory With the Same Counterparty"

STATUS: Tentative Conclusion Reached

IMPACT: Companies that buy and sell (or exchange) inventories with the same counterparty.

NEXT STEPS: The Task Force recommended that a draft abstract of this tentative conclusion be posted for public comment prior to the September 2005 meeting. Further discussion of this Issue is expected.

An entity may buy from and sell inventory to another entity that operates in the same line of business. The purchase and sale transactions may be documented as a single contractual arrangement (e.g., an inventory exchange) or documented in separate contractual arrangements (e.g., separate invoices and gross cash settlement for the purchase and sale). While this inventory practice is common in the oil and gas industry (oil for oil swaps), this issue arises in many industries. The inventory purchased or sold may consist of raw materials, work-in-process, or finished goods. The following questions have been raised regarding the accounting:

1. If nonmonetary transactions within the scope of APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, involve inventory, are there any circumstances under which the transactions should be recognized at fair value rather than at recorded amounts?
2. Under what circumstances should two or more transactions with the same counterparty (counterparties) be viewed as a single nonmonetary transaction within the scope of Opinion 29?

At the March meeting, the Task Force discussed the first question and reached a tentative conclusion that exchanges of inventory in the same line of business should be accounted for as shown in the following table.

Sold	Received		
	Raw Material	Work-in-Process	Finished Good
Raw Material	Recorded amount	Recorded amount	Recorded amount
Work-in-Process	Recorded amount	Recorded amount	Recorded amount
Finished Good	Fair value*	Fair value*	Recorded amount

\* The other requirements of paragraph 20 of Opinion 29, as amended by FASB Statement No. 153, *Exchanges of Nonmonetary Assets — an amendment of APB Opinion No. 29*, also must be considered in order to record a nonmonetary transaction at fair value: fair value must be determinable within reasonable limits and the transaction must have commercial substance. Further, the Task Force observed that this Issue does not address whether these transactions qualify for revenue recognition.

The basis of the tentative conclusion is that a company that gives up a finished good in return for a component of producing inventory (i.e., raw materials or work-in-process) has culminated the earning process. As the inventory classification is critical to the application of the tentative conclusion, the EITF considered whether further guidance on classification should be included in the Issue. However, the Task Force concluded that a company should use its own entity-specific criteria to classify inventory for financial reporting purposes in accordance with Accounting Research Bulletin No. 43, Chapter 4, "Inventory Pricing." SEC Regulation S-X, Rule 5-02, "Balance Sheets," requires public companies to disclose their inventory classification.

At the June 2005 EITF meeting, the Task Force considered the recommendations of the working group on the complex question of when two or more inventory transactions with the same counterparty should be viewed as a single nonmonetary transaction.

The Task Force agreed that the issuance of invoices and the settlement of each in cash is not a factor that should be considered if an inventory exchange is, in substance, a nonmonetary transaction. The Task Force reached a tentative conclusion to require that inventory purchase and sales transactions with the same counterparty that are entered into in contemplation of one another should be combined for purposes of applying Opinion 29.

The working group identified the following indicators that should be considered in making the determination as to whether transactions were entered into in contemplation of one another:

- (1) There is a legal right of **offset of obligations** between counterparties involved in inventory purchase and sales transactions.
- (2) Inventory purchase and sales transactions with the same counterparty are entered into simultaneously with one another.
- (3) Inventory purchase and sales transactions were at off-market terms.
- (4) Certainty that reciprocal inventory transactions with the same counterparty will occur.

The Task Force concluded that a more comprehensive list of indicators is needed and recommended that a draft abstract of this tentative consensus, with a request for additional indicators, be posted for public comment prior to the September 2005 meeting.

Any final consensus reached under this Issue likely will be effective prospectively and allow time for preparers to modify systems.

## Issue No. 05-1, “Accounting for the Conversion of an Instrument That Becomes Convertible Upon the Issuer’s Exercise of a Call Option”

STATUS: Tentative Conclusion Reached

IMPACT: Issuers of contingently convertible debt instruments and certain other instruments that can become convertible upon the exercise of a call option.

NEXT STEPS: Task Force is considering an alternative model wherein, if the shares underlying the instrument previously were included in the denominator in diluted EPS, the instrument becoming convertible upon the issuer’s exercise of a call option would have no effect on income. However, if the shares underlying the instrument had not been included previously in diluted EPS, exercise of the call and any resulting conversion would result in an extinguishment loss. Further discussion is expected.

Issue No. 04-8, “The Effect of Contingently Convertible Instruments on Diluted Earnings per Share,” required contingently convertible instruments (CoCos) to be included in diluted earnings per share regardless of whether the contingency had been met. An example of a CoCo follows:

On January 1, 20X5, Company B (B) issues a 15-year CoCo for \$1,000. The instrument is convertible into 10 shares of B’s underlying 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.

In addition to being convertible once the market price contingency has been met, the instrument includes a provision that allows B (the issuer) to call the CoCo anytime between 20X9 and the maturity date. If B exercises the call, the holder has the option to receive cash of \$1,000 as settlement of the debt or receive 10 shares. Accrued interest is ignored for purposes of this example.

This Issue addresses the accounting if B calls the CoCo when, absent the call, it cannot otherwise be converted (i.e., the market price contingency has not been met) and the holder elects to receive the 10 shares. For example, B calls the CoCo and the holder elects to receive shares when the stock price is \$110 per share. APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued With Stock Purchase Warrants*, does not address directly many of the complex convertible instruments that currently exist.

At the March meeting, the Task Force reached a tentative conclusion to account for conversion of the instrument in the same way as other conversions of a convertible instrument under Opinion 14. That is, the carrying amount of the debt should be reclassified to equity and no gain or loss would be recognized.

At the June meeting, the Task Force discussed the EPS treatment of instruments other than CoCos. One instrument they focused on is an instrument that is never convertible until and if the issuer exercises its call option. Consider the following:

Company A (A) issues \$1,000 of debt at par with a maturity date of 10 years. A has the right to call the debt anytime after five years from the date of issuance. If A exercises the call, the holder has the option to receive cash of \$1,000, or receive 10 shares. Accrued interest is ignored for purposes of this example. The holder of the debt can only require conversion of the debt once it has been called by A.

Company A calls the debt six years after issuance when its stock price is \$150 per share. The holder elects to receive the 10 shares valued at \$1,500. Pursuant to the tentative conclusion reached, A will reclassify the carrying amount of the debt (\$1,000) to equity and not recognize any gain or loss.

How should this instrument be treated in the calculation of A’s earnings per share prior to its conversion?

Some believe that the instrument falls under the guidance in paragraph 29 of FASB Statement No. 128, *Earnings per Share*, while others believe that the instrument falls under the contingently issuable share guidance in Statement 128.

- Under paragraph 29 of Statement 128, A could overcome the presumption of share settlement (and ignore the instrument when calculating its diluted EPS) if it has a stated policy or past experience that provides a reasonable basis that the instrument will be settled in cash.
- Under the contingently issuable share guidance, the shares would not be included in diluted EPS prior to A calling the debt because the holder cannot exercise the settlement option until the issuer exercises the call option.

Task Force members were troubled that the instrument described above could be converted without either a charge to income or any impact on diluted EPS prior to conversion. As such, the Task Force asked the staff to research the following alternatives for discussion at the September meeting:

- View A — Account for conversion of instruments **included in diluted EPS prior to conversion** in the same way as other conversions of a convertible instrument under Opinion 14. That is, the carrying amount of the debt should be reclassified to equity and no gain or loss would be recognized.
- View B — Account for the conversion of instruments **not included in diluted EPS prior to conversion** as a debt extinguishment under APB Opinion No 26, *Early Extinguishment of Debt*. That is, on the date the holder converts the instrument, a gain or loss should be calculated as the difference between the carrying amount of the debt and the fair value of the stock issued.

### **Issue No. 05-2, “The Meaning of ‘Conventional Convertible Debt Instrument’ in EITF Issue No. 00-19, ‘Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock’”**

STATUS: Final Consensus Reached

IMPACT: Entities issuing non-vanilla convertible debt or convertible preferred stock with a mandatory redemption date.

NEXT STEPS: FASB ratification expected in June.

Issue 00-19 is used (among other purposes) to evaluate whether an issuer is required to bifurcate a conversion option, under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, that is embedded in convertible debt. Bifurcation of a conversion option is not required for the issuer if the conversion option would meet the requirements to be classified as equity under Issue 00-19. Paragraph 4 of Issue 00-19 provides an exception to applying some of its specific requirements for equity classification if the “contract is a **conventional convertible debt instrument** in which only the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).” **[Emphasis added]**

The Task Force discussed whether the exception to the requirements of paragraphs 12–32 of Issue 00-19 for “conventional convertible debt instruments” should be removed or further clarified. Consider the following:

Conventional convertible debt instruments may contain a provision that requires the delivery of registered shares upon conversion of the instrument. In accordance with paragraphs 14–18 of Issue 00-19, a requirement to deliver registered shares is deemed to be outside the control of the issuer, and, therefore, it is assumed that the company will be required to net-cash settle the contract. Absent the exception in paragraph 4, the conversion option would be bifurcated from the host contract and recorded as a separate liability.

The Task Force reached a consensus that the exception to the requirements of paragraphs 12–32 of Issue 00-19 for **conventional convertible debt instruments** should be retained and further clarified as follows:

Instruments that provide the holder with an option to convert into a fixed number of shares, and the ability to exercise that option is based on the passage of time or a contingent event, should be considered “conventional.”

The Task Force concluded that a contingency is not relevant in determining whether the instrument is “conventional.” Rather, the ultimate form of settlement should be considered. That is, if upon resolution of the contingency, the instrument is convertible into a fixed number of shares, the instrument is no different than a non-contingent convertible instrument in respect to form of settlement.

The following are examples of “conventional” and non-conventional instruments under this consensus:

“Conventional”	Not “Conventional”
<ul style="list-style-type: none"> <li>Contingently convertible debt instruments (Including debt instruments with rights to contingently issuable shares based on price contingencies and other contingencies).</li> </ul>	<ul style="list-style-type: none"> <li>Instrument C of EITF Issue No. 90-19, “Convertible Bonds With Issuer Option to Settle for Cash Upon Conversion” (the number of shares issuable is not fixed).</li> </ul>
<ul style="list-style-type: none"> <li>Convertible debt instruments with conversion ratio changes for standard anti-dilution (e.g., stock splits, stock dividends, recapitalization, etc.).</li> </ul>	<ul style="list-style-type: none"> <li>Convertible debt instruments with floating conversion ratios that adjust based on the stock price of the underlying shares.</li> </ul>
<ul style="list-style-type: none"> <li>Mandatorily redeemable convertible preferred stock (see discussion below).</li> </ul>	<ul style="list-style-type: none"> <li>Convertible debt instruments with conversion ratios that adjust to conform to subsequent issuances bearing lower conversion prices.</li> </ul>

The Task Force also reached a consensus that convertible preferred stock with a mandatory redemption date may qualify for the exception in paragraph 4 of Issue 00-19 depending on whether the instrument is more akin to debt or equity.

The consensus of Issue 05-2 shall be effective prospectively for all new instruments and modifications to existing instruments entered into after FASB ratification (Expected at the June 29 Board meeting).

**Issue No. 05-3, “Accounting for Rental Costs Incurred During the Construction Period”**

- STATUS: Failed to reach a consensus and issue removed from EITF agenda
- IMPACT: Entities incurring rental costs associated with ground and building leases during the construction of an asset that is directly related to the leased property.
- NEXT STEPS: FASB to consider issuing a FSP. The FSP may conclude that rental costs should be expensed during the construction period.

In some lease arrangements, an entity (lessee) may take possession of, or be given control of, leased property prior to commencing operations and making rental payments under the terms of the lease. The leased property may include land, building(s), or both. During this period, the entity has the right to use the leased property (for example, for purposes of the construction of an asset such as leasehold improvements). After construction is completed, the entity commences operations and is required to make rental payments in accordance with the terms of the lease. Alternatively, some lease arrangements may require the lessee to commence rental payments when the lessee takes possession of or is given control of the leased property.

FASB Technical Bulletin No. 88-1, *Issues Related to Accounting for Leases*, requires rental costs associated with operating leases to be allocated on a straight-line basis to periods beginning when the lessee takes possession of or is given control of the leased property, regardless of when (a) the lessee’s operations commence or (b) the lessee is required to make payments under the terms of the lease.

Currently, diversity in practice exists. Some entities capitalize rental costs that are incurred during the construction period of an asset while others have elected to expense the rental costs.

The Task Force was unable to reach a consensus after considering four views that ranged from a prohibition on capitalizing rent to a requirement that rent must be capitalized. The FASB agreed to consider addressing the topic and the issue was removed from the EITF Agenda. Five FASB Board members indicated at the meeting that they were in support of requiring expensing the rental costs.

**Issue No. 05-4, “The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to EITF Issue No. 00-19, ‘Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock’”**

- STATUS: No Decisions Reached
- IMPACT: Entities issuing instruments (e.g., stock warrants) that are settled in the issuer’s own shares accompanied by a registration rights agreement with a liquidated damages clause. The agreement calls for cash payments if the issuer, within a certain grace period, fails to have the registration of the underlying shares declared effective.
- NEXT STEPS: The Task Force asked the staff to prepare an analysis on whether the registration rights agreements is a derivative under Statement 133.

Registration rights agreements that include a liquidated damages clause commonly accompany the issuance of equity instruments, stock purchase warrants, and financial instruments that are convertible into the issuer's own shares. Typically, the agreement requires the issuer to use its "best efforts" to file a registration statement (for the resale of equity instruments or shares of stock underlying a stock purchase warrant) and have it declared effective by the end of a specified grace period. If the issuer fails to have the registration statement declared effective within the grace period (or if effectiveness is not maintained), the issuer is required to pay liquidated damages to the investor each month until the registration statement is declared effective.

Currently, there is diversity in practice as to whether the registration rights agreement and the related financial instrument should be viewed as one combined freestanding instrument or accounted for as separate freestanding arrangements. If the registration rights agreement is considered separate, there are diverse views on whether the agreement is a derivative or a contingent liability. Further, if the agreements are viewed as a single unit, practice also is diverse regarding the assessment of the unit as either a derivative instrument in its entirety, or equity.

The Task Force was asked to discuss the following alternatives at its June meeting:

- View A — The registration rights agreement and the financial instrument agreement should be considered together as a unit and analyzed under Issue 00-19. If the maximum potential liquidated damages penalty, payable in cash, is greater than a reasonable estimate of the difference in fair value between registered and unregistered shares, the combined instrument should be classified as a liability under Issue 00-19 and accounted for as a derivative.
- View B — The registration rights agreement and the financial instrument agreement should be considered together as a unit and accounted for as a derivative under Statement 133. The combined instrument is not considered "Indexed to the Company's Own Stock" as described in EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock,'" or View B1, the combined instrument is considered "Indexed to the Company's Own Stock," but requires partial cash settlement, and, therefore, would be classified as a liability.
- View C — The registration rights agreement and the financial instrument agreement are separate freestanding agreements and should be accounted for separately. The financial instrument is classified as equity under the provisions of Issue 00-19, and the registration rights agreement is accounted for under Statement 133.

The Task Force failed to make progress on the issue, partly because differing views were expressed on whether the liquidated damages clause is a separate instrument and, when analyzed on a stand-alone basis, whether the clause meets the definition of a derivative instrument. The Task Force asked the staff to prepare an analysis on whether the registration rights agreements is a derivative for discussion at the next meeting in September.

## **Issue No. 05-5, "Accounting for the Altersteilzeit Early Retirement Programs"**

STATUS: Final Consensus Reached

IMPACT: U.S. companies with German subsidiaries or non-U.S. companies that provide benefit arrangements for employees under an Altersteilzeit (ATZ) Early Retirement Program or an arrangement with the same terms.

NEXT STEPS: FASB ratification expected in June.

The Altersteilzeit arrangement is an early retirement program in Germany designed, in part, as an incentive toward early retirement. Typically, ATZ arrangements offer the following two alternatives to employees:

- Type I — Participants work 50 percent of the time for each year of the entire ATZ period, and receive 50 percent of their normal salary each period.
- Type II — Participants work full-time for half of the ATZ period and do not work for the remaining half of the ATZ period. Salary for each year of the entire ATZ period is 50 percent of the normal salary.

In addition to salary payments, participants also receive termination benefits consisting of a bonus and additional employer contributions to the German government pension scheme on behalf of the ATZ participants. Most employees participating in ATZ arrangements select the Type II arrangement.

The following illustrates the relationship between the work performed and cash compensation received by a participant under a Type II ATZ arrangement:

Year	Percent Worked	Percent of Salary Paid	Termination/Retirement Paid (as Percent of Full-Time Salary)	Total
1	100%	50%	10%	60%
2	100%	50%	10%	60%
3	0%	50%	10%	60%
4	0%	50%	10%	60%

The Task Force concluded that the salary payments under a Type I and Type II arrangement should be recognized ratably over the portion of the ATZ period when the employee is providing active services (the “active service period”). The portion of the salary that is deferred under the Type II arrangement would be discounted if payment is expected to be greater than one year.

The Task Force, after reviewing several alternatives, reached a consensus that the termination benefit of a Type II ATZ arrangement should be accounted for as a termination benefit under FASB Statement No. 112, *Employers’ Accounting For Postemployment Benefits*. Accruals for the cost of benefits commence at the time an individual employee enrolls in the ATZ arrangement and should be accrued ratably from the date the employee signs the ATZ contract to the end of his active service period.

The German government provides a subsidy (reimbursement) to an employer for the termination benefits paid under an ATZ arrangement for a maximum of six years. In order to receive this subsidy, an employer must meet certain criteria (typically, an employer must hire replacement employees from currently registered unemployed persons or former trainees). The Task Force considered whether the subsidy should be accounted for in the assumptions for determining the costs of the termination benefit. Ultimately, the Task Force reached a consensus that a company should account for the government subsidy when it meets the criteria necessary to receive it. In reaching the consensus, the Task Force concluded that the subsidy is a separate and distinct component from the termination benefit.

If the final consensus is ratified by the FASB (expected at the FASB’s June meeting), Issue 05-5 would be effective for the first fiscal year that begins after December 15, 2005. Adoption of this consensus should be reported as a change in accounting estimate as described in paragraph 19 of FASB Statement No. 154, *Accounting Changes and Error Corrections*. Disclosures required by paragraph 22 of Statement 154, should be provided.

### **Issue No. 05-6, “Determining the Amortization Period for Leasehold Improvements”**

STATUS: Final Consensus Reached

IMPACT: Entities acquiring leasehold improvements in a business combination and all other entities that incur significant leasehold improvements whose useful life extend beyond the *term* of the lease.

NEXT STEPS: FASB ratification expected in June.

Questions have been raised regarding the determination of the amortization period for leasehold improvements that are purchased subsequent to the inception of the lease (that is, leasehold improvements that are not placed in service (or contemplated) at or near the beginning of the initial lease term).

A reasonably assured lease term under FASB Statement No. 13, *Accounting for Leases*, includes the fixed non-cancelable term plus all periods covered by bargain renewal options and all other periods where failure to renew will impose a penalty on the lessee in such an amount that will make renewal reasonably assured. The lease-term cannot be extended to periods beyond which a contractual right to lease exists.

At the June meeting, the Task Force reached a consensus that leasehold improvements placed in service significantly after and not contemplated at, or near, the beginning of the lease term, should be amortized over the lesser of the useful life of the assets or a term that includes renewals that are reasonably assured at the date the leasehold improvements are purchased. This consensus applies only to purchases of significant leasehold improvements as a result of a single capital investing decisions. The issue does not address reassessment of (1) the amortization period for leasehold improvements that pre-exist the newly purchased leasehold improvements, or (2) reassessment of the lease term for purposes of lease classification and recognition of lease payments.

The EITF Agenda Committee agreed to consider at its next meeting (August) whether a separate issue should be added to the Agenda to address the amortization period for pre-existing leasehold improvements upon a significant addition of leasehold improvements.

The Task Force reached a similar consensus with respect to all leasehold improvements acquired in a business combination. This consensus only addresses the amortization period for leasehold improvements. Lease classification and recognition of lease payments should be accounted for under FASB Interpretation No. 21, *Accounting for Leases in a Business Combination*, and Statement 13.

If ratified by the FASB, the consensus reached will be effective for periods beginning after Board ratification. The consensus should be applied prospectively to the amortization period for newly acquired and the unamortized portion of existing leasehold improvements that were either (a) purchased subsequent to the inception of the lease (if they qualify) or (b) acquired in a business combination.

## **Modifications to Consensus**

### **Consensus Modification — Issue No. 01-9, “Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor’s Products)”**

The FASB staff has received questions about the scope of Issue 4 in Issue 01-9 and whether the decision tree appropriately reflects the consensus. The decision tree indicates that consideration that is delivered at the point of sale is within the scope of Issue 01-9 and that consideration that is delivered at other than the point of sale is not within its scope. The Task Force originally concluded that if the consideration is cash and it is receivable by the customer as a result of a single exchange transaction, then Issue 01-9 applies, regardless of when the customer receives the cash (for example, a cash rebate that is mailed to the customer after the sales transaction). In contrast, if a sales incentive is offered in the form of product or services, and the delivery is after the point of sale, Issue 01-9 does not apply. Accordingly, the decision tree has been updated to clarify the Task Force’s original consensus.

Additionally, the Task Force agreed to add a footnote to Issue 4 to clarify the interaction between the consensus in Issue 4 and the scope of Issue 01-9. That is, Issue 01-9 does not address the accounting for an offer to a customer, in connection with a current revenue transaction, for free or discounted products or services from the vendor that is redeemable by the customer at a future date without a further exchange transaction with the vendor.

### **Consensus Modification — Issue No. 04-6, “Accounting for Stripping Costs Incurred During Production in the Mining Industry”**

At the March meeting, the Task Force reached a consensus that stripping costs incurred during production are variable production costs that should be included in the costs of the inventory produced. At the June meeting, the Task Force agreed to clarify the term “inventory produced” to indicate that their intention was that inventory produced would only include inventory extracted.

The Task Force reached a consensus to conform the transition guidance of Issue 04-6 to be consistent with FASB Statement No. 154, *Accounting Changes and Error Corrections*, to state that entities should recognize the cumulative effect of initially applying this consensus as a change to opening retained earnings in the period of adoption.

### **Consensus Modification — Issue No. 04-10, “Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds”**

The Task Force previously decided that the effective date of the consensus in Issue 04-10 should coincide with the effective date of FASB Staff Position (FSP) No. FAS 131-a, “Determining Whether Operating Segments Have ‘Similar Economic Characteristics’ Under Paragraph 17 of FASB Statement No. 131, *Disclosures About Segments of an Enterprise and Related Information*,” since the two issues were interrelated. At the May 18, 2005 Board meeting, the Board decided not to issue the proposed FSP FAS 131-a, because the proposed FSP would not have met its objective of reducing the current diversity in financial reporting. The Board based its decision on its review of the comment letters, discussions with constituents, and discussions with the SEC staff. Since the Board plans no further action on this issue, the Task Force agreed to reconsider the effective date of Issue 04-10.

The Task Force agreed that the consensus in Issue 04-10 should be effective for fiscal years ending after September 15, 2005. Additionally, consistent with the Task Force’s previous decision, the corresponding information for earlier periods, including interim periods, should be restated unless it is impractical to do so.

## Agenda Committee Report

### Added to EITF Agenda for discussion at a future meeting — Accounting for Modifications to Conversion Options Embedded in Debt Securities and Related Issues

When the terms of debt agreements are modified, entities are required to assess whether the modification results in an extinguishment of the debt pursuant to the guidance in EITF Issue No. 96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments.” Often, the modifications to convertible debt agreements also would change the terms of the conversion option (for example, a change to the conversion price, the number of underlying shares, or the conversion period). A SEC staff speech (December 2004 AICPA Conference on Current SEC and PCAOB Developments) addressed the accounting for modifications of conversion options in convertible securities under Issue 96-19. The SEC staff stated that entities should consider the change in fair value of the conversion option immediately before and after the modification of the debt in applying Issue 96-19 to determine if the debt was modified or extinguished.

The SEC speech did not provide any further guidance on how to account for the change in the value of the conversion option if an entity concluded that the modification of the debt and conversion option did not result in an extinguishment of debt pursuant to Issue 96-16. The issue was added to the Agenda to provide further guidance.

### Added to EITF Agenda for discussion at a future meeting — Income Tax Consequences of Issuing Convertible Debt With a Beneficial Conversion Feature

When a company issues convertible debt with a beneficial conversion feature, the debt is bifurcated into a liability component and an equity component in accordance with EITF Issue No. 98-5, “Accounting for Convertible Securities With Beneficial Conversion Features or Contingently Adjustable Conversion Ratios,” and EITF Issue No. 00-27, “Application of Issue No. 98-5 to Certain Convertible Instruments.” The equity component is measured at the intrinsic value of the beneficial conversion feature on the commitment date. For income tax purposes, all of the proceeds are recorded as a liability and nothing is recorded in shareholders’ equity.

At issue is whether the issuance of convertible debt with a beneficial conversion feature results in a book-tax basis difference. Additionally, if there is a basis difference, another issue is whether the difference is a temporary or permanent.

### Item removed from Agenda Committee (FSP to be issued) — Offsetting of a Right to Receive or an Obligation to Return Cash Collateral With a Net Derivative Position Under a Master Netting Arrangement

A company may enter into a master netting arrangement related to its derivative contracts with a counterparty. If the company is in a net-receivable derivative position, the company may require collateral to be posted (e.g., the counterparty provides the company with cash or securities as collateral for the derivative contract). If the company is in a net payable derivative position, it may be required to post collateral with the counterparty.

Currently, there is diversity in practice on whether companies offset in the balance sheet receivables or obligations related to the collateral against the net derivative asset or liability. This diversity exists because of differences in how preparers apply FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*.

The FASB Board has agreed to address the issue through the issuance of a FASB Staff Position.

### Not added to EITF Agenda (FSP likely) — Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Asset Retirement Obligations

FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, requires that an entity recognize the fair value of a liability for an asset retirement obligation (ARO) in the period in which it is incurred if a reasonable estimate of fair value can be made. FASB Statement No. 52, *Foreign Currency Translation*, generally requires that transaction gains and losses on foreign currency denominated monetary assets and liabilities be reported in earnings. If an entity assumes that an ARO will be settled in a foreign currency (assume that there is no legal requirement to settle the obligation in a foreign currency), the change in the fair value of the obligation would include the changes resulting from (a) revisions to the timing or the amount of the original estimate of undiscounted cash flows, and (b) the change in the exchange rate between the foreign currency and the entity’s functional currency.

At Issue is whether the changes in an ARO liability should be bifurcated between (a) changes in cash flow estimates resulting from revisions to the timing or the amount of the original estimate of undiscounted cash flows; and (b) changes resulting from fluctuations in foreign exchange rates.

The Agenda Committee decided not to add this issue to the EITF's agenda. Based on a request from the Agenda Committee, the FASB staff agreed to pursue the issuance of a FASB Staff Position to provide guidance on this Issue.

### **Upcoming EITF Events**

The next EITF meeting is scheduled for September 14–15, 2005. On September 20, 2005, Deloitte & Touche will host a Dbriefs webcast on the topics discussed at the meeting. [Join Dbriefs](#) to be notified of this and other upcoming webcasts.

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