

EITF Roundup

Audit and Enterprise Risk Services

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This issue of *EITF Roundup* covers the September 15, 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). On September 28, 2005, the FASB is expected to ratify consensus decisions reached at the September EITF meeting. Official EITF minutes and EITF meeting materials distributed to the Task Force are posted to the [Deloitte Accounting Research Tool](#) Web site and the FASB Web site.

The Task Force discussed the following topics:

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

STATUS: Final Consensus Reached

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

NEXT STEPS: FASB ratification expected in September.

An entity may buy inventory from and sell inventory to another entity that operates in the same line of business. The purchase and sales 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). This inventory practice 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:

- Issue 1. Under what circumstances should two or more transactions with the same counterparty be viewed as a single nonmonetary transaction within the scope of APB Opinion No. 29, *Accounting for Nonmonetary Transactions*?

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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Issue 2. If nonmonetary transactions within the scope of Opinion 29 involve inventory, are there any circumstances under which the transactions should be recognized at fair value rather than at recorded amounts?

On the first issue, the Task Force reached a consensus that two or more inventory transactions with the same counterparty should be viewed as a single nonmonetary transaction for purposes of applying Opinion 29, if the transactions were entered into in contemplation of one another. The Task Force agreed that the following indicators should be considered in making the determination as to whether transactions were entered into in contemplation of one another:

- (1) There is a specific 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.
- (3) Inventory purchase and sales transactions were at off-market terms at inception of the arrangement.
- (4) Certainty that reciprocal inventory transactions with the same counterparty will occur.

The Task Force noted that the issuance of invoices and the settlement of each transaction in cash is not a relevant factor in determining if an inventory exchange is, in substance, a nonmonetary exchange transaction.

For the second issue, the Task Force reached a consensus requiring entities to account for exchanges of inventory in the same line of business at fair value or recorded amounts based on inventory classification 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 for this consensus is that an entity that transfers a finished good in return for a component of producing inventory (i.e., raw materials or work-in-process) has culminated the earning process for the finished good. 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.

Inventory exchange transactions combined under the first issue may involve cash consideration. The Task Force concluded that entities should follow the guidance in Opinion 29 and EITF Issue No. 01-2, "Interpretations of APB Opinion No. 29," to account for exchanges involving monetary consideration (boot). If boot is significant, paragraph 19 of Issue 01-2 requires that exchange transactions should be recorded at fair value by both parties. **Significant** is defined as at least 25 percent of the fair value of the exchange. If the boot in a transaction is less than 25 percent, the pro-rata gain recognition guidance in paragraph 22 of Opinion 29 should be applied by the receiver of the boot, and the payer of the boot would not recognize a gain.

If the final consensus is ratified by the FASB (expected at the FASB's September 28 meeting), Issue 04-13 will be effective for new (including renegotiated or modified) inventory arrangements entered into in the first interim or annual reporting period beginning after March 15, 2006.

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

STATUS: No Decision Reached

AFFECTS: Issuers of contingently convertible debt instruments and certain other instruments that are not currently convertible but become convertible upon the exercise of a call option.

NEXT STEPS: The Task Force will explore, at the next meeting, a variation of View B.

APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued With Stock Purchase Warrants*, does not address directly many of the complex features currently embedded in convertible debt. This issue addresses the accounting for a conversion of a debt instrument into issuer shares triggered by an issuer calling the debt when, absent the call, the debt was not convertible. Consider the following example:

On January 1, 20X5, Company B (B) issues convertible debt for \$1,000. The instrument is convertible into 10 shares of B’s underlying common stock (implying a conversion price of \$100 per common share). 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.

The instrument includes a provision that allows B (the issuer) to call it 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. Assume that the stock price has never reached \$120.

Company B calls the debt when the stock price is \$110 and the holder elects to receive the 10 shares. How should B account for issuance of the 10 shares?

The Task Force was unable to reach a consensus and views were divided between the following:

- View B — Account for the equity securities issued akin to a conversion, rather than a debt extinguishment; provided that the debt instrument may, absent exercise of the call option, become convertible upon the passage of time or upon the occurrence of a substantive contingency outside the control of the issuer; or
- View D — Account for equity securities issued to settle the debt instrument at their fair value. That is, the difference between (1) the fair value of the equity securities issued, and (2) the carrying amount of the debt instrument settled, should be recorded as a debt extinguishment gain or loss.

For the example above, under View B, the shares issued would be recorded at the carrying amount of the debt converted. No gain or loss would be recognized because the original terms of the instrument provided that it could become convertible upon the occurrence of a substantive contingency outside the control of the issuer (the \$120 market price trigger).

Under View D, the issuer would record the equity securities at \$1,100 (fair value) and recognize \$100 as a debt extinguishment loss.

The Task Force agreed to explore, at the next meeting, a variation of View B above — conversion accounting would apply upon exercise of the call if the conversion option was substantive at issuance.

Issue No. 05-7, “Accounting for Modifications to Conversion Options Embedded in Debt Securities”

STATUS: Final Consensus Reached

AFFECTS: Entities modifying the conversion terms of convertible debt securities.

NEXT STEPS: FASB ratification expected in September.

When terms of debt agreements are modified, debt issuers are required to assess whether the modification results in an extinguishment of the debt and the issuance of **new** debt pursuant to the guidance in EITF Issue No. 96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments.” The assessment requires issuers to analyze whether the modification produces a significant change in the cash flows of the debt. Modifications to convertible debt agreements may change the terms of the embedded conversion option (for example, a change to the conversion price, the number of underlying shares, or the conversion period).

The Task Force reached a consensus that debt issuers are required to include the change in the fair value of a modified conversion option as a cash flow in their Issue 96-19 analysis to determine whether the modification resulted in an extinguishment of the debt and the issuance of **new** debt (EITF Issue Summary: Issue 1, View A). When modifications result in an extinguishment of the debt, the **new** debt should be recorded at fair value and that amount should be used to determine the debt extinguishment gain or loss.

If the modification does not result in an extinguishment of the debt, the change in the fair value of the conversion option should be recorded as a discount (or premium) associated with the debt with a corresponding offset to equity (EITF Issue Summary: Issue 2, View A).

The Task Force also considered, under Issue 3 of the EITF Issue Summary, whether the change in the intrinsic value of the conversion option should be measured and recorded separately as a beneficial conversion feature. The Task Force reached a consensus that debt issuers should not recognize a new beneficial conversion feature or reassess an existing beneficial conversion feature (EITF Issue Summary Issue 3, View B).

The consensus should be applied prospectively to future modifications of debt instruments in reporting periods beginning after December 15, 2005 (subject to FASB ratification). However, public companies should consider the remarks of the SEC staff, at the December 2004 AICPA Conference on Current SEC and PCAOB Developments, stating that it is the staff's belief that public companies should include the change in fair value of a modified conversion option in their Issue 96-19 cash flow analysis.

Issue No. 05-8, "Income Tax Consequences of Issuing Convertible Debt With a Beneficial Conversion Feature"

STATUS: Final Consensus Reached

AFFECTS: Entities issuing convertible debt with a beneficial conversion feature accounted for under 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."

NEXT STEPS: FASB ratification expected in September.

For financial statement reporting purposes beneficial conversion features, embedded in convertible instruments, initially are recognized separately in equity and measured at intrinsic value. Consider the following example:

Company A (A) issued convertible debt at par for proceeds of \$100. The debt is convertible, three years after issuance, into four shares of the company's common shares. At issuance the fair market value of four common shares is \$120. That is, the intrinsic value of the beneficial conversion feature is \$20 at the commitment date. For financial reporting purposes, A recognizes cash proceeds of \$100, convertible debt with a net book basis of \$80 (\$100 less \$20 debt discount), and a beneficial conversion feature in additional paid-in capital of \$20.

For income tax purposes the entire amount of the proceeds received at issuance of the debt (\$100) is treated as the tax basis of the convertible debt security.

The Task Force reached a consensus that the issuance of convertible debt with a beneficial conversion feature results in a tax/book basis difference that should be accounted for as a temporary difference for purposes of applying FASB Statement No. 109, *Accounting for Income Taxes*, (EITF Issue Summary: Issues 1 and 2, View A). The Task Force further concluded that the recognition of deferred taxes for the temporary difference should be recorded as an adjustment to additional paid-in capital (EITF Issue Summary: Issue 3, View A). That is, recognition of deferred taxes for the temporary difference will not impact the income statement and the effective income tax rate.

The consensus is effective for reporting periods beginning after December 15, 2005, and should be applied retrospectively to all instruments with a beneficial conversion feature. FASB ratification of the consensus is expected at the September 28 Board meeting.

Modifications to Earlier Items

Consensus Modification — Issue No. 05-6, “Determining the Amortization Period for Leasehold Improvements”

At the June 2005 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 (i.e., the amortization period may be different than the lease term).

The Task Force modified this consensus to clarify that it does not apply to preexisting leasehold improvements. That is, the consensus reached in Issue 05-6 cannot be used to justify the reevaluation of preexisting leasehold improvements for additional renewal periods when new leasehold improvements are placed into service significantly after and are not contemplated at or near the beginning of the lease term.

Modification — Topic No. D-98, “Classification and Measurement of Redeemable Securities”

The SEC observer provided the Task Force with proposed changes to Topic D-98. One set of changes provides guidance on the application of Topic D-98 to share-based payment arrangements with employees and are consistent with the guidance in SEC Staff Accounting Bulletin Topic 14, “Share-Based Payment” (SAB 107).

A second set of changes, related to redeemable common shares, introduces a new method, akin to the two-class method of calculating earnings per share, to calculate earnings per share when a class of common stock is redeemable at other than fair value.

Agenda Committee Report

No new items were added to, or removed from, the agenda committee report.

Sale of Held-to-Maturity Securities and Other Hurricane Katrina Related Accounting Guidance

Typically, when an entity sells a held-to maturity security, it calls into question its intent to hold other debt securities to maturity in the future. However, paragraph 8 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, states that “events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated may cause the enterprise to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity.” At its September 15, 2005, meeting, the EITF stated that selling held-to-maturity securities as a result of Hurricane Katrina may meet this exception criterion, depending on the entity’s circumstances.

The Task Force Chairman stated that neither the EITF nor the FASB intended to provide additional specific accounting guidance for the events related to Hurricane Katrina. However, the Chairman indicated that the AICPA has posted to its Web site, AICPA Technical Practice Aid 5400.05, “Accounting and Disclosures Guidance for Losses from Natural Disasters — Nongovernmental Entities,” that identifies certain issues related to accounting for losses from natural disasters.

Upcoming EITF Events

The next EITF meeting is scheduled for November 9 and 10, 2005, if a sufficient number of topics justify holding the meeting. If the EITF meets, Deloitte & Touche will host a *Dbriefs* webcast on November 15, 2005, covering the topics discussed at the meeting. [Join Dbriefs](#) to be notified of this and other upcoming webcasts.

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