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EITF Roundup

Audit and Enterprise Risk Services

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This issue of *EITF Roundup* covers the June 15, 2006, meeting of the Emerging Issues Task Force (EITF or Task Force). The EITF put into place new operating procedures effective with its March 2006 meeting. All initial Task Force decisions, referred to as "tentative conclusions," will be exposed for a 30-day comment period upon ratification by the Financial Accounting Standards Board (FASB or Board). At its first scheduled EITF meeting subsequent to the comment period, the Task Force will consider comments received, redeliberate as deemed necessary, and, as warranted, affirm its tentative conclusions as consensuses. Consensuses are not final until ratified by the FASB.

At the June 28, 2006, FASB meeting, the Board ratified the consensuses reached at the June EITF Meeting. The Board also ratified the tentative conclusions reached and approved exposure of the tentative conclusions for a 30-day comment period. The next EITF meeting following the comment period is scheduled for September 6 and 7, 2006.

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. 05-1, "Accounting for the Conversion of an Instrument That Becomes Convertible Upon the Issuer's Exercise of a Call Option"

STATUS: Consensus Reached

AFFECTS: Issuers of many contingently convertible debt instruments and certain other instruments that are not currently convertible pursuant to their terms. Upon the issuer's exercise of a call option, these instruments become convertible, resulting in the issuance of equity securities in accordance with the original terms of the instrument.

EFFECTIVE: The consensus is effective for all conversions within its scope that result from the exercise of call options in interim or annual reporting periods beginning after June 28, 2006. For instruments issued before the effective date, the assessment as to whether a substantive conversion feature exists at issuance should be based on assumptions, considerations, and/or marketplace information available as of the issuance date.

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

> On January 1, 20X5, Company A (A) issues convertible debt for $1,000. The instrument is convertible into 100 shares of A's underlying common stock (implying a conversion price of $10 per common share). However, the investor does not have the right to convert unless the market price of A's stock exceeds $15 for a specified consecutive number of days.
>
> The instrument includes a provision that allows A to call it anytime between 20X8 and the maturity date. If A exercises the call, the holder has the option to receive cash of $1,000 as settlement of the debt or receive 100 shares. Accrued interest is ignored for purposes of this example. Assume the stock price never reaches $15.
>
> Company A calls the debt when the stock price is $11, and the holder elects to receive the 100 shares. How should A account for issuance of the 100 shares?

The Task Force affirmed its tentative conclusion to account for the call option and the resulting equity securities issued akin to a conversion (i.e., no gain or loss); provided that the debt instrument, **at issuance**, contains a substantive conversion feature. The transaction, otherwise, should be recorded as a debt extinguishment. A substantive conversion feature is one that, at issuance, is at least reasonably possible (as defined in FASB Statement No. 5, *Accounting for Contingencies*) of becoming exercisable absent the issuer's ability to call the instrument.

In the example above, Company A will need to determine if the contingent conversion option is substantive at the issuance date of the debt. One indicator could be that the coupon on the issued debt is lower than the coupon it otherwise could get for similar, but not convertible, debt.

If the conversion option is substantive, the shares issued as a result of the call should be recorded at the carrying amount of the debt converted (i.e., $1,000). However, if A concludes that the conversion option is not substantive at the issuance date, the equity securities issued will be recorded at $1,100 (fair value) with $100 recognized as a loss on debt extinguishment.

The requirement to assess whether the conversion option is substantive should be performed as of the issuance date of the debt; however, the assessment may be performed after the issuance date. If so, the assessment should be based only on assumptions, considerations, and/or marketplace information available as of the issuance date.

Issue No. 06-1, "Accounting for Consideration Given by a Service Provider to Manufacturers or Resellers of Equipment Necessary for an End-Customer to Receive Service From the Service Provider"

STATUS: Tenative Conclusion Reached

AFFECTS: Specialized service providers, such as certain cell phone or satellite media companies that provide consideration to manufacturers or resellers of the equipment necessary for the end-customers to utilize their services.

EFFECTIVE: A consensus would be effective for the first annual reporting period beginning after June 15, 2007. Entities would recognize the effects of applying the consensus as a change in accounting principle through retrospective application to all prior periods.

NEXT STEPS: The tentative conclusion will be exposed for a 30-day comment period beginning on, or after July 6, 2006.

Specialized service providers often give consideration to manufacturers or resellers of equipment necessary for an end-customer to utilize their service, commonly in an effort to reduce the price of the equipment (or, otherwise, increase end-customer demand for the service). For transactions to be within the issue's scope, the service provider must not purchase, take title of, or sell the equipment directly to the end-customer. Consider the following example:

Company Z (Z) provides satellite television service to its subscribers. Subscribers are required to purchase a specific type of Digital Video Recorder (DVR) to receive Z's satellite signal. Company Z does not sell or manufacture DVRs; however, Z entered into a contractual arrangement with the reseller of the DVRs, under which the price of the DVR to the end-customer is reduced by $150 — provided the customer signs up for satellite service. When the customer activates the service, Z reimburses the reseller for the $150 discount. If the customer does not activate the service, the customer owes the reseller $150.

The Task Force focused first on how to characterize the consideration paid to a manufacturer or reseller, assuming the resulting benefit is, in fact, linked to the end-customer. The Task Force reached a tentative conclusion that the consideration provided to a manufacturer or reseller should be characterized based on the form of consideration the service provider directs to the end-customer. Income statement characterization is based on EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)." That is, "cash" consideration is characterized as a reduction of revenue; "other than cash" consideration is characterized as an expense. If the form of consideration is **not** directed by the service provider, then it should be characterized as "other than cash." For purposes of applying this issue, the term "cash" does not include sales incentives that reduce the price of the equipment (which would be considered "cash" in Issue 01-9).

The Task Force also reached a tentative conclusion that if the consideration given by a service provider can be contractually linked to the benefit received by the end-customer, it is, in substance, the same as consideration given directly to the end-customer. Lastly, the Task Force reached a tentative conclusion that the development of a new accounting model to account for these transactions is not necessary (i.e., apply the Issue 01-9 model as described above).

Some Task Force members believe that such consideration, regardless of its form, should be considered "other than cash," provided the consideration received by the end-customer does not exceed the price paid by the end-customer for the equipment. If the consideration received by the end-customer exceeds the equipment price, the excess should be considered "cash." The Task Force tentatively rejected this view based primarily on concerns that the service provider may not have access to end-customer-pricing information. However, in connection with the exposure of the tentative conclusion reached, the Task Force will seek input regarding this alternative view, including whether it is operational.

Issue No. 06-2, "Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, *Accounting for Compensated Absences*"

STATUS: Consensus Reached

AFFECTS: Entities, such as some high-tech companies that provide employees with a compensated absence under a sabbatical or other similar benefit arrangement.

EFFECTIVE: The consensus is effective for fiscal years beginning after December 15, 2006. Entities should recognize the effects of applying the consensus as a change in accounting principle through a cumulative-effect adjustment to retained earnings. Retrospective application to all prior periods is allowed, but not required.

Questions have been raised regarding the accounting for certain compensated absence arrangements under sabbatical leave or similar types of arrangements. At issue are arrangements that (a) require completion of a minimum service period before the employee is entitled to the compensated absence, (b) do not increase with additional years of service, and (c) do not require the employee to render service to the employer during the leave. Consider the following arrangement:

> Once an employee has provided eight years of service to an entity, he or she is entitled to a ten-week sabbatical leave. During the sabbatical, the employee continues to be compensated, with no service requirement to the entity. Should the employer accrue a liability over the required service period?

Paragraph 6 of Statement 43 provides guidance for the accounting of compensated absences and states in part that a future obligation should be accrued as a liability if the "obligation relates to rights that vest or accumulate." In practice, the types of benefit arrangements discussed in this issue are earned on a cliff basis, with no payout obligation if the service is rendered but the employee terminates prior to taking the leave (i.e., the benefit does not vest). At issue, therefore, is whether the benefit accumulates pursuant to Statement 43.

The Task Force affirmed its tentative conclusion that the employee's right **does accumulate**; therefore, it should be accrued over the required service period. The basis for this conclusion is that the "unused right" does not expire at the end of each year during the service period and that prior service is a factor in determining eligibility.

Issue No. 06-3, "Disclosure Requirements for Taxes Assessed by a Governmental Authority on Revenue-Producing Transactions"

STATUS: Consensus Reached

AFFECTS: Entities with taxes that are imposed by a governmental authority concurrently on a specific revenue-producing transaction between a seller and a customer.

EFFECTIVE: The consensus should be applied to financial reports through retrospective application for all periods presented, if amounts are significant, for interim and annual reporting periods beginning after December 15, 2006.

At the 2005 AICPA National Conference on Current SEC and PCAOB Developments, an SEC staff member discussed the income statement presentation of vendor taxes. The staff member remarked that entities that collect and remit taxes from customers should determine whether those taxes should be presented on a gross or net basis in the income statement. Entities should consider the types of taxes involved and whether the entities are acting in an agent or primary obligor capacity, as contemplated in EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal Versus Net as an Agent." Since that time, questions have been raised on how to apply those remarks to different types of taxes, and whether a "primary obligor" model is appropriate in making the gross versus net determination for such taxes.

The Task Force affirmed its tentative conclusion that the scope of this issue includes any tax assessed by a governmental authority that is imposed concurrently on a specific revenue-producing transaction between a seller and a customer. The Task Force also clarified that this issue's scope excludes gross receipts taxes.

For taxes within the issue's scope, the Task Force affirmed its tentative conclusion that entities should present such taxes on either a gross (i.e., include in revenues and costs) or net (i.e., exclude from revenues) basis based on their accounting policies — which should be disclosed pursuant to APB Opinion No. 22, *Disclosure of Accounting Policies*. If such taxes are reported gross and are significant, entities should disclose the amounts of those taxes. Disclosures may be made on an aggregate basis.

Entities are not required to reevaluate their existing accounting policies related to taxes within the issue's scope as a result of this consensus. Entities that choose to reevaluate their existing policies and elect to change the presentation of such taxes must do so in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*. As such, a change would need to be deemed preferable.

Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements"

STATUS:	Tentative Conclusion Reached
AFFECTS:	Entities with endorsement split-dollar life insurance policies that provide a benefit to an employee that extends into the employee's postretirement period. Certain COLI or BOLI ("company-owned life insurance" or "bank-owned life insurance") policies would be affected.
EFFECTIVE:	A consensus would be effective for fiscal years beginning after December 15, 2006. Entities would recognize the effects of applying the consensus as a change in accounting principle through a cumulative-effect adjustment to retained earnings. Retrospective application to all prior periods would be allowed, but not required.
NEXT STEPS:	The tentative conclusion will be exposed for a 30-day comment period beginning on, or after July 6, 2006. The Task Force requested the FASB staff to research whether the tentative conclusion should apply also to collateral split-dollar life insurance arrangements. The EITF Agenda Committee will consider adding an issue to the agenda based on the research results.

In a typical endorsement split-dollar life insurance arrangement, an employer purchases a policy to insure the life of an employee. The employer owns the policy, controls the rights of ownership, and may terminate the policy at anytime. As a benefit of employment, the employer endorses a portion of the policy death benefit to the employee, with the employee designating a beneficiary. Upon the death of the employee, the employee's beneficiary receives the designated portion of the death benefit and the employer receives the remainder, if any, commonly in addition to the policy's cash surrender value.

The Task Force acknowledged that the future death benefit promised to the employee represents a postretirement benefit obligation within the scope of FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, (if part of a postretirement plan) or APB Opinion No. 12, *Omnibus Opinion — 1967*. However, views were initially divided on whether the purchase of the endorsement split-dollar life insurance policy effectively settles the obligation.

Ultimately, a tentative conclusion was reached that the employer should recognize a liability for the future death benefit as the postretirement benefit obligation is not effectively settled through the purchase of the endorsement split-dollar life insurance policy. The Task Force looked to the definition of a settlement under the provisions of Statement 106, concluding that the purchase of the policy does not qualify as such.

Issue No. 06-5, "Accounting for Purchases of Life Insurance — Determining the Amount That Could Be Realized in Accordance With FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*"

STATUS: Tentative Conclusion Reached

AFFECTS: Entities that own life insurance policies, including COLI or BOLI.

EFFECTIVE: A consensus would be effective for fiscal years beginning after December 15, 2006. Entities would recognize the effects of applying the consensus as a change in accounting principle through a cumulative-effect adjustment to retained earnings. Retrospective application to all prior periods would be allowed, but not required.

NEXT STEPS: The tentative conclusion will be exposed for a 30-day comment period beginning on, or after July 6, 2006.

When an entity purchases a life insurance policy Technical Bulletin No. 85-4 requires that "the amount that could be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset." The amount that "could be realized" is commonly the policy's cash surrender value; however, depending on the terms of the policy, other amounts may be considered realizable. Typical amounts that may be considered realizable beyond cash surrender value include experience reserve account balances and recovered deferred acquisition costs. Generally, these amounts are credited back to the policy holder's account balance over time, which reduces the overall cost of insurance. An insurance company also may assess a charge upon surrender of the policy. However, this charge may be waived, commonly, when multiple individual policies are surrendered on a group basis.

At issue is what amount or amounts "could be realized" under Technical Bulletin 85-4. Consider the following example:

In January 20X0, Company A purchased a group life insurance policy that covered 10 executives, which required a single premium payment of $1,000,000 at policy inception. The policy is comprised of 10 individual life insurance certificates. At December 31, 20X5, the policy has the following values:

- $900,000 cash surrender value, net of $100,000 of surrender charges ($10,000 per individual certificate). If all certificates are surrendered at the same time, the insurance company will waive the surrender charge.
- $50,000 of experience reserve credits, reflecting favorable actual-to-expected experience to date. This balance is payable if all individual certificates are surrendered as a group.
- $25,000 of deferred acquisition cost credits, calculated on a present value basis. There are no contractual restrictions on these amounts (i.e., amounts are recoverable on a certificate-by-certificate basis even when individual certificates are surrendered).

The Task Force reached a tentative conclusion that entities should consider any additional amount(s) (i.e., beyond cash surrender value) included in the contractual terms of the policy in determining the amount that "could be realized." Contractual limitations should be considered when determining realizable amounts, and amounts recoverable at the insurance company's discretion should be excluded from the amount that could be realized. Recoverable amounts that are long-term in nature may need to be recognized at their present value depending on the nature of the arrangement.

The Task Force also reached a tentative conclusion that the amount that "could be realized" should be determined on the individual policy (or certificate) level.

Accordingly, in the above example, the amount that could be realized at December 31, 20X5, under the tentative conclusion would be $925,000, equaling the $900,000 cash surrender value (net of the surrender charges) plus the $25,000 of deferred acquisition cost credits.

Issue No. 06-6, "Application of EITF Issue 05-7, 'Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues'"

STATUS: No Decision Reached — Previous Consensus Remains in Effect

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

EFFECTIVE: Continue to apply prospectively to modifications of debt instruments beginning in the first interim or annual reporting period beginning after December 15, 2005.

NEXT STEPS: The FASB staff will explore other possible methods to evaluate whether the modification results in a substantial change in the terms of the debt instrument. The Task Force plans on continuing its debate at the September 2006 meeting.

Due to questions raised in practice, the Task Force revisited the accounting for the modification of a conversion option when the modification does not result in an extinguishment of the related debt [previously reached consensus on Issue 05-7 — Issue 2]. At issue is the recognition of the change in fair value of a conversion option in situations where the conversion option is either eliminated or its fair value is reduced. Under the consensus, the recognition of the elimination or reduction in fair value of the conversion option results in a debit to equity, equal to the change in fair value of the conversion option. Some question whether this treatment is appropriate, when the value of the conversion option was not originally recorded in equity. An alternative treatment would be to record the debit in the income statement, akin to a debt extinguishment.

The Task Force could not agree on the accounting for such a modification; instead, deciding to revisit, at a future meeting, its previously reached consensus on Issue 05-7 — Issue 1. This issue addresses how the change in fair value of a conversion option should be considered in evaluating whether there has been a substantial change in the terms of the debt instrument pursuant to EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments." Under the Issue 05-7 — Issue 1 consensus, the Issue 96-19 calculation — which considers a change of at least 10 percent in the present value of the cash flows under the modified debt instrument when compared to the remaining cash flows under the original terms to be "substantially different" — is performed on a net basis. That is, the (a) net change in the consideration paid or received related to the modification and (b) resulting change in fair value of the conversion option, are viewed on a net basis in determining whether there has been a substantial change in the terms of the debt. The Task Force raised questions about whether the net calculation may result in otherwise substantial modifications not being identified as such.

The Task Force instructed the FASB staff to explore other possible methods to evaluate whether such a modification results in a substantial change in the terms of the debt. This issue is expected to be discussed at the September 6 and 7, 2006, EITF meeting.

Agenda Committee Report

Added to the agenda is "Accounting for a Previously-Bifurcated Conversion Option in Convertible Debt That No Longer Meets the Bifurcation Criteria in paragraph 12 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*"

In certain circumstances, a conversion option embedded in a debt instrument is required to be bifurcated from its debt host and accounted for as a separate derivative. For example, this may be the case when the conversion option does not qualify for equity classification under EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock." However, the facts and circumstances may change after issuance of the debt, such that the conversion option no longer requires separate derivative accounting. Consider the following example:

> On January 1, 20X5, Company A (A) issues convertible debt. At issuance, A does not have a sufficient number of authorized but unissued common shares to satisfy the conversion option. As such, the conversion option does not qualify for equity classification, and is bifurcated from its debt host and recorded as a separate derivative. On July 1, 20X5, A authorizes additional common shares, such that there are now sufficient shares available to satisfy the conversion option. As a result, the conversion option is no longer required to be accounted for as a separate derivate.

At issue is the accounting treatment for the previously-bifurcated conversion option. Currently, diversity exists in accounting for the removal of the freestanding derivative, with treatments including (a) reclassification to equity, (b) recombination with the debt host, or (c) some combination thereof, perhaps with an income statement impact to the extent the recombination results in a negative yield on the debt instrument.

Next EITF Meeting

The next EITF meeting is scheduled for September 6 and 7, 2006. Deloitte & Touche will host a *Dbriefs* webcast on September 13, 2006, covering the topics discussed at the meeting. Join *Dbriefs* to be notified of this and other upcoming webcasts.

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