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EITF Snapshot

Audit and Enterprise Risk Services

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This *EITF Snapshot* summarizes the March 15, 2007, meeting of the Emerging Issues Task Force (EITF or "Task Force").

Initial Task Force decisions ("tentative conclusions") are exposed for a comment period upon ratification by the Financial Accounting Standards Board (FASB or "Board"). At its first scheduled meeting after the comment period, the Task Force considers comments received and, as warranted, affirms its tentative conclusions as consensuses. Consensuses are then provided to the Board for ratification.

After the March 28, 2007, FASB meeting, official EITF minutes, including the results of the FASB's ratification process, will be posted to Technical Library: The Deloitte Accounting Research Tool and to the FASB's Web site. EITF Issue summaries also can be found on those sites. Effective with the March 2007 meeting, this publication replaces our *EITF Roundup*.

In the Spotlight

SEC Staff Announcement: Issues Surrounding Application of "Critical-Terms-Match" Hedge Accounting

Joseph McGrath made an informal announcement regarding the SEC staff's view on the application of "critical-terms-match" hedge accounting under paragraph 65 of Statement 133.[1] His points dealt with situations where a registrant concluded that there was no ineffectiveness in the hedging relationship because the "critical terms" of the hedging instrument and the hedged asset or liability matched. However, in fact, there was some ineffectiveness because certain other terms did not match. Said another way, while there was not an exact match, the registrant concluded the terms were "essentially matched."

This issue surfaced in a December speech given by Timothy Kviz, professional accounting fellow in the Office of the Chief Accountant of the SEC. Mr. Kviz indicated that it is inappropriate to apply a method that simply assumes no ineffectiveness to hedging relationships in which known sources of variability that could create ineffectiveness exist. Two common hedging strategies that apply the critical-terms-match method — and in which **all** terms may not necessarily align — are hedges of forecasted sales transactions denominated in a foreign currency and commodity hedges.

Hedgers who use the critical-terms-match method should confirm the basis for their assertion that ineffectiveness will be de minimis by making a quantitative assessment. According to Mr. McGrath, registrants should:

- Revisit their existing critical-terms-match hedging relationships and confirm the reasonableness of their original assessments (i.e., that the hedging relationship is, in fact, highly effective, and that any ineffectiveness is de minimis).
- If they haven't already, make a quantitative assessment (specifics were not prescribed) to determine that ineffectiveness has been de minimis.
- If the results of this analysis support the reasonableness of a registrant's original conclusion that the hedging terms are "essentially matched," then it should continue with its application of the critical-terms-match hedge accounting.

Mr. McGrath also provided certain parameters in performing assessments of hedges of forecasted foreign currency denominated transactions where the forecasted transactions occur over a stated period (i.e., monthly or quarterly) but the hedging instrument settles once during the period. It may be reasonable to conclude (pending the outcome of the quantitative assessment) that the terms are "essentially matched" when the hedging instrument and the hedged transactions settle within one month of each other. However, when settlement is outside of a one-month window, Mr. McGrath urged the registrant to discuss the situation with the SEC staff.

In April, the FASB will consider adding to its agenda a project that may address questions about the critical-terms-match method — which terms are "critical" and how closely must they match in order to assume there is no ineffectiveness to record or assess.

[1] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

Issue 06-10 Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements

STATUS: Consensus reached.

AFFECTS: Entities, including many privately owned companies not subject to the Sarbanes-Oxley Act of 2002, that participate in collateral assignment split-dollar life insurance arrangements that extend into an employee's retirement period. These arrangements are often referred to as "key-person" life insurance.

BACKGROUND: There are two common types of split-dollar life insurance arrangements: endorsement (see EITF Issue 06-4[2]) and collateral assignment. The following is an example of a typical **collateral assignment** arrangement:

Company X (X) funds the purchase of a $10 million life insurance policy on the life of its CEO, making a one-time premium payment of $1 million. The CEO owns and controls the policy, with certain restrictions (e.g., restriction on access to the policy's cash surrender value), and names a beneficiary. In return for funding the premium, the CEO assigns — as collateral — a portion of the policy's death benefit to X such that X, upon the CEO's death, will receive the $1 million premium paid plus a 5 percent return.

The key difference between an endorsement and a collateral assignment arrangement is who owns and controls the underlying life insurance policy — the employer (endorsement) or employee (collateral assignment). Issue 06-4 requires an employer to recognize a liability for the postretirement benefit obligation associated with an **endorsement** arrangement on the basis of the substantive nature of the agreement with the employee. At issue is (1) whether to apply the accounting model for an endorsement arrangement to a collateral assignment arrangement and (2) how to recognize and measure the asset associated with a collateral assignment arrangement.

SUMMARY: The Task Force reached a consensus that an employer should recognize a liability for the postretirement benefit obligation related to a collateral assignment arrangement — in accordance with Statement 106[3] (if deemed part of a postretirement plan) or Opinion 12[4] (if not part of a plan) — if, based on the substantive agreement with the employee, the employer has agreed to maintain a life insurance policy during the postretirement period or provide a death benefit. The Task Force also reached a consensus that an employer should recognize and measure the associated asset on the basis of the terms of the collateral assignment arrangement.

TRANSITION: Effective for fiscal years beginning after December 15, 2007, including interim periods within those fiscal years. Recognize the effects as a change in accounting principle through either (1) a cumulative-effect adjustment as of the beginning of the year of adoption or (2) retrospective application to all prior periods. Earlier application is permitted.

NEXT STEPS: FASB ratification is expected on March 28, 2007.

Issue 06-11 Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards

STATUS: Tentative conclusion reached; "APIC pool" accounting unresolved.

AFFECTS: Entities that pay dividends or dividend equivalents (hereinafter referred to as "dividends") that are charged to retained earnings on employee-held, equity-classified nonvested shares; nonvested share units; or outstanding share options (together, "affected securities").

BACKGROUND: In a share-based payment arrangement, employees may receive dividend protection features that entitle them to dividends either (1) during the vesting period for nonvested shares or share units or (2) until the exercise date for share options. Consider the following example:

Company Y (Y) has an employee stock option plan with dividend protection in the form of payments equal to dividends paid on the underlying shares. On January 1, 20X8, Y must pay its outstanding

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

[3] FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.*

[4] APB Opinion No. 12, *Omnibus Opinion — 1967.*

option holders an amount equal to a $0.25 dividend paid on the underlying shares, regardless of whether the underlying shares ultimately vest.

Dividend payments generally can be treated as a deductible compensation expense for income tax purposes, thereby generating an income tax benefit for the employer. At issue is how such a realized tax benefit should be recognized.

At its November 2006 meeting, the Task Force reached a tentative conclusion that an entity should recognize the realized tax benefit as an increase in additional paid-in capital (APIC), and that the amount recognized in APIC should be included in the pool of excess tax benefits available to absorb tax deficiencies on share-based payment awards (i.e., the "APIC pool").

Subsequently, questions were raised about how to account for a realized tax benefit previously recognized in APIC when (1) the related award is no longer expected to vest (and therefore must be reclassified from retained earnings to the income statement) and (2) the tax benefit already may have been applied against a tax shortfall on another share-based award.

SUMMARY: The Task Force reaffirmed its tentative conclusion reached at the November 2006 meeting; however, it was unable to decide on a method to account for the reclassification of previously recognized tax benefits from APIC to the income statement for awards no longer expected to vest.

TRANSITION: As currently drafted, a consensus would be applied prospectively to the income tax benefits of dividends declared on affected securities in fiscal years beginning after September 15, 2007.

NEXT STEPS: The FASB staff will prepare examples of applying the various alternatives for reclassifying previously recognized tax benefits from APIC to the income statement for consideration at the June 2007 EITF meeting.

Issue 07-1 Accounting for Collaborative Arrangements Related to the Development and Commercialization of Intellectual Property

STATUS: Tentative conclusion reached — Issue 2; no decisions reached — Issues 1 and 3.

AFFECTS: Entities, particularly those in the biotechnology, pharmaceutical, and motion picture industries, that participate in collaborative arrangements for the joint development and commercialization of intellectual property.

BACKGROUND: Entities often seek partners to share in the development and commercialization of resource-intensive (and generally uncertain) products. Although these arrangements take many forms, their substance is one of active participation by two parties who agree to share in the related costs and potential revenues. Consider the following example:

Company B, a small biotechnology company, has a promising drug candidate. Company P is a large pharmaceutical company with an established manufacturing facility and distribution chain. Companies B and P enter into a collaborative arrangement for the joint development and commercialization of the potential drug, agreeing to actively participate in the endeavor and to share the costs and potential revenues.

Questions have arisen about (1) what constitutes a collaborative arrangement, (2) how the parties should present costs incurred and revenue generated on sales to third parties in their respective income statements, and (3) how the parties should present cost-sharing payments, profit-sharing payments, or both (i.e., any payments between the parties) in their respective income statements.

SUMMARY: The Task Force considered the recommendation of a working group, formed to consider aspects of the issue, that a collaborative arrangement may be characterized by one or more of the following indicators:

- Partners are active participants in the arrangement.
- Partners are exposed to risks and rewards that depend on the commercial success of the endeavor.

- Partners financially participate in the arrangement through termination or commercialization.
- Partners have a contractual or legal right to the underlying intellectual property.
- A mechanism is present that grants the partners participation rights (e.g., a steering committee).

While the Task Force acknowledged that the indicators are instructive in identifying a collaborative arrangement, it has not yet been asked to affirm the working group's recommendation.

The Task Force reached a tentative conclusion that costs incurred and revenues generated on sales to third parties should be reported by the partners in their respective income statements on a gross or net basis depending on whether the partner is deemed the principal or agent for the given transaction pursuant to Issue 99-19.[5]

Finally, the Task Force did not reach a decision about how cost- and revenue-sharing payments between the partners should be presented in their respective income statements.

NEXT STEPS: The FASB staff will prepare additional presentation and disclosure examples for the classification of cost- and revenue-sharing payments between the partners for consideration at the June 2007 EITF meeting. A future meeting of the working group will seek to refine the indicators.

Issue 07-2 Accounting for Convertible Debt Instruments That Require or Permit Partial Cash Settlement Upon Conversion

STATUS: No decision reached.

AFFECTS: Issuers of convertible debt instruments that require or permit partial cash settlement upon conversion (provided that the embedded conversion option is not separately accounted for as a derivative pursuant to Statement 133). This includes "Instrument C"[6] and certain convertible preferred shares that are accounted for as mandatorily redeemable financial instruments under Statement 150.[7]

BACKGROUND: The issuance of Instrument C (and convertible debt instruments with similar characteristics) has proliferated in recent years because of the low-interest-rate coupon associated with convertible debt, and with the favorable earnings-per-share (EPS) treatment afforded to these instruments[8] compared with "conventional" convertible debt. Consider the following example:

Company X (X) issues $100 million of Instrument C bonds. Because of the conversion option, the bonds bear interest at 2 percent. For EPS purposes, X applies the treasury stock method, which is generally less dilutive than the if-converted EPS method applied to conventional convertible debt.

Some question whether Instrument C (and convertible debt instruments with similar characteristics) is specifically contemplated in the scope of Opinion 14,[9] asserting that the substance of the transaction is the sale of a (1) debt instrument and (2) conversion option — resulting in higher interest expense due to the bifurcation of the debt and embedded conversion option.

SUMMARY: The Task Force did not reach a decision about whether Instrument C (and convertible debt instruments with similar characteristics) was contemplated in the scope of Opinion 14. Issuers should continue to apply existing guidance.

NEXT STEPS: The Task Force recommended the formation of a smaller working group to consider approaches to resolve the issue, including a comprehensive approach addressing past convertible debt accounting issues that have been considered by the EITF.

Issue 07-3 Accounting for Advance Payments for Goods or Services to Be Used in Future Research and Development Activities

STATUS: Tentative conclusion reached.

AFFECTS: Entities whose outsourced research and development (R&D) activities include nonrefundable advance payments for the delivery of future goods or services.

[5] EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal Versus Net as an Agent."

[6] As described in EITF Issue No. 90-19, "Convertible Bonds With Issuer Option to Settle for Cash Upon Conversion."

[7] FASB Statement No. 150, *Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity.*

[8] See Issue 90-19 for the related accounting and EPS guidance.

[9] APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued With Stock Purchase Warrants.*

BACKGROUND: Entities that perform R&D activities, including manufacturing activities on the behalf of others, often require **nonrefundable** advance payments to secure the future delivery of their goods or services. Consider the following example:

Company M (M), a manufacturing company, is developing a new product and has engaged Company R (R), a contract research organization, to perform R&D services on M's behalf. On January 1, 20X8, M makes a nonrefundable advance payment to R for R&D services that will commence on May 15, 20X8.

There is diversity in how purchasers of R&D services account for nonrefundable advance payments, with entities either (1) expensing the payments when made (or when an obligation is incurred) or (2) deferring the expense (e.g., prepaid R&D expense).

SUMMARY: The Task Force reached a tentative conclusion that nonrefundable advance payments for future R&D activities should be deferred and capitalized until the goods have been delivered or the related services have been performed.

TRANSITION: A consensus would be effective for fiscal years beginning after December 15, 2007, including interim periods within those fiscal years. Apply as a change in accounting principle through a cumulative-effect adjustment as of the beginning of the year of adoption.

NEXT STEPS: FASB ratification is expected at the Board's March 28, 2007, meeting, after which the tentative conclusion will be exposed for a comment period.

D-Topics

- Proposed EITF Topic No. D-109, "Determining the Nature of a Host Contract Related to a Hybrid Financial Instrument Issued in the Form of a Share Under FASB Statement No. 133."

  Whether a host contract in a hybrid instrument is considered debt or equity is key to whether embedded derivatives need to be bifurcated under Statement 133. The SEC observer announced the staff's view that the determination of the nature of a host contract, issued in the form of a share, should be based on a consideration of economic characteristics and risk, and should not ignore any of the other stated or implied substantive terms and features of the hybrid instrument.

  Editor's Note: Some accountants have held a narrower view that may have overemphasized the form of the host in determining whether it is a liability or equity.

  The view should be initially applied as of the first day of the first fiscal quarter after June 15, 2007, in a manner consistent with the transition provisions for embedded derivatives in Question 2 of Implementation Issue K5.[10] Alternatively, the SEC staff will not object to prospective application to all hybrid financial instrument contracts entered into, modified, or otherwise subject to a remeasurement event in fiscal quarters beginning after June 15, 2007.

  The SEC observer solicited suggestions to improve the clarity of the proposed D-Topic.

- EITF Topic No. D-98, "Classification and Measurement of Redeemable Securities."

  The SEC updated Topic D-98 to reflect the issuance of FSP EITF 00-19-2[11] and certain other items.

[10] Statement 133 Implementation Issue No. K5, "Miscellaneous: Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues."

[11] FASB Staff Position No. EITF 00-19-2, "Accounting for Registration Payment Arrangements."

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

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