

# EITF Snapshot

Audit and Enterprise Risk Services

June 2007

by Brian Maloney and Adrian Mills, Deloitte & Touche LLP

This *EITF Snapshot* summarizes the June 14, 2007, meeting of the Emerging Issues Task Force.

Initial Task Force decisions (“tentative conclusions”) are exposed for a comment period upon ratification by the Financial Accounting Standards 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 June 27, 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.

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

**STATUS:** Consensus reached.

**AFFECTS:** Entities that pay dividends or dividend equivalents that are charged to retained earnings on employee-held, equity-classified nonvested shares, nonvested share units, or outstanding share options (“affected securities”).

**BACKGROUND:** In a share-based payment arrangement, employees may receive dividend protection features entitling them to receive 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’s employee stock option plan provides dividend protection in the form of equal participation in dividends paid on the underlying shares while the options are outstanding. On March 31, 20X8, Y declares and pays a \$0.25 dividend to its common shareholders. Accordingly, Y pays its outstanding option holders a \$0.25 dividend. For options expected to vest, Y charges the dividend to retained earnings.

Generally, dividend payments — including those charged to retained earnings — can be treated as deductible compensation expense for income tax purposes, resulting in a tax benefit to the employer. At its March 15, 2007, meeting, the Task Force reaffirmed its tentative conclusion that (1) an entity should recognize a **realized** tax benefit from dividends charged to retained earnings on affected securities as a credit to additional paid-in capital (APIC) and (2) the credit to APIC should be included in the pool of excess tax benefits available to absorb tax deficiencies from share-based payment awards (i.e., the “APIC pool”).

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.

Deloitte & Touche is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte & Touche shall not be responsible for any loss sustained by any person who relies on this publication.

One remaining issue is the accounting for a tax benefit from dividends on affected securities that were previously expected to vest but that are forfeited (or are no longer expected to vest) — more specifically, whether (and to what extent) a tax benefit previously recognized in APIC should be reclassified to the income statement when an entity's estimate of forfeitures increases or actual forfeitures exceed its estimates.

**SUMMARY:** The Task Force reached a consensus that an entity should recognize a realized tax benefit associated with dividends on affected securities charged to retained earnings as an increase in APIC. The amount recognized in APIC should be included in the APIC pool.

When an entity's estimate of forfeitures increases or actual forfeitures exceed its estimates, the amount of tax benefits previously recognized in APIC should be reclassified into the income statement; however, the amount reclassified is **limited to** the APIC pool balance on the reclassification date.

**TRANSITION:** Apply prospectively to the income tax benefits of dividends declared on affected securities in fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Earlier application is permitted as of the beginning of a fiscal year for which interim or annual financial statements have not been issued.

**NEXT STEPS:** FASB ratification is expected on June 27, 2007.

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

**STATUS:** Tentative conclusion reached.

**AFFECTS:** Entities, particularly those in the biotechnology, pharmaceutical, and motion picture industries, that participate in collaborative arrangements for the development and commercialization of products.<sup>1</sup>

**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 the collaborators and a sharing of the costs and revenues of the endeavor. Consider the following example:

Company B, a biotechnology entity, has a promising drug candidate. Company P is a pharmaceutical company with an established manufacturing facility and distribution chain. The companies enter into an arrangement for the collaborative development and commercialization of the potential drug. No legal entity is created; however, B and P agree that:

- B will perform the development activities.
- P will perform the commercialization activities (if and when the drug is approved for sale).
- B and P will share in the costs and revenues (if any) of the endeavor.

Questions have arisen about (1) what constitutes a collaborative arrangement; (2) how the partners, in their respective income statements, should present costs incurred and revenue generated on sales to third parties; (3) how amounts owed to (due from) the partners should be presented; and (4) what financial statement footnote disclosures should be provided.

**SUMMARY:** The Task Force reached a tentative conclusion that the presence of the following two indicators creates a rebuttable presumption that a collaborative arrangement exists:

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

Both indicators must be present in order to conclude that a collaborative arrangement exists. In addition, the presence of the following characteristics — which are not intended to be all-inclusive — may provide clarification that a collaborative arrangement exists:

- Through the arrangement, the partners have a contractual or other legal right to own, access, or use the underlying intellectual property.

<sup>1</sup> A collaborative arrangement may include a legal entity in some portion of the arrangement. Any consensus reached on Issue 07-1 does not affect the accounting for that legal entity under existing generally accepted accounting principles.

- There is a steering committee or other mechanism to provide decision-making rights to the partners.

The Task Force affirmed its previously reached tentative conclusion that costs incurred and revenues generated on sales to third parties should be reported by the partners on the appropriate line item in their respective income statements, pursuant to Issue 99-19.<sup>2</sup>

A tentative conclusion was also reached that the income statement characterization of amounts owed to (due from) the partners should be based on the nature of the arrangement, the respective entity's business operations, and whether the payments are within the scope of other authoritative literature. If the payments are within the scope of other authoritative literature, income statement characterization should be based on such literature; otherwise, characterization should be based on (1) analogy to other authoritative literature or (2) a reasonable, rational, and consistently applied accounting policy election.

Finally, the partners should disclose, in the footnotes to their annual financial statements, (1) income statement amounts (and related classification) attributable to the arrangement, (2) amounts owed to (due from) the participants, and (3) prescribed qualitative information regarding the nature and purpose of the arrangement.

**TRANSITION:** A consensus would be effective for fiscal years beginning after December 15, 2007, applied as a change in accounting principle through retrospective application to all periods presented.

**NEXT STEPS:** FASB ratification is expected at the Board's June 27, 2007, meeting, after which the tentative conclusion will be exposed for a comment period.

### Issue 07-2 **Accounting for Convertible Debt Instruments That Are Not Subject to the Guidance in Paragraph 12 of APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued With Stock Purchase Warrants***

**STATUS:** The Task Force was unable to reach a decision. See Next Steps below.

**AFFECTS:** Potentially the issue could have affected issuers of a wide range of convertible debt instruments, including, but not limited to, Instrument C.<sup>3</sup>

**BACKGROUND:** The issuance of Instrument C bonds (and convertible debt instruments with similar characteristics) has proliferated in recent years because of the low-interest-rate coupon associated with convertible debt and the favorable earnings-per-share (EPS) treatment afforded to these instruments<sup>4</sup> 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.

Ultimately at issue is which convertible debt instruments are within the scope of paragraph 12 of Opinion 14. For instance, some question whether Instrument C is specifically contemplated in the scope of Opinion 14, asserting that the substance of the transaction is the sale of a (1) debt instrument and (2) conversion option. Others question whether convertible debt instruments with features that could result in an adjustment to the conversion rate for reasons other than nonstandard antidilution provisions (e.g., make-whole provisions, ordinary dividends)<sup>5</sup> are contemplated in Opinion 14's scope.

**NEXT STEPS:** FASB members at the meeting indicated a willingness to address the accounting for convertible debt instruments that require or permit settlement of the if-converted value (or any portion thereof) in cash, most likely in the form of an FSP.

<sup>2</sup> EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal Versus Net as an Agent."

<sup>3</sup> As described in EITF Issue No. 90-19, "Convertible Bonds With Issuer Option to Settle for Cash Upon Conversion."

<sup>4</sup> See Issue 90-19 for the related accounting and EPS guidance.

<sup>5</sup> Standard antidilution provisions are those that result in adjustments to the conversion ratio in the event of an entity-restructuring transaction (as defined in the glossary of FASB Statement No. 123(R), *Share-Based Payment*) and that are designed to maintain the value of the conversion option.

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

**STATUS:** Consensus reached.

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

**BACKGROUND:** Entities that perform R&D activities on behalf of others, including manufacturing-related R&D, often require **nonrefundable** advance payments to secure 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 its behalf. As part of the agreement, on January 1, 20X8, M makes a nonrefundable advance payment to R for services that will commence in May 2008.

The accounting for nonrefundable advance payments is diverse, with entities either (1) expensing the payments when made (or when an obligation is incurred) or (2) deferring and capitalizing the expense (e.g., prepaid R&D) until the goods are received or services are performed.

**SUMMARY:** The Task Force reached a consensus that nonrefundable advance payments for future R&D activities should be capitalized and recognized as an expense as the goods are delivered or services are performed.

**TRANSITION:** Effective for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Apply prospectively to new contracts entered into on or after the effective date.

**NEXT STEPS:** FASB ratification is expected on June 27, 2007.

### Issue 07-4 **Application of the Two-Class Method Under FASB Statement No. 128, *Earnings per Share*, to Master Limited Partnerships**

**STATUS:** No decision reached.

**AFFECTS:** Publicly traded master limited partnerships (MLPs) that issue incentive distribution rights (IDRs). This ownership structure is common in industries such as petroleum and natural gas extraction and transportation.

**BACKGROUND:** A typical MLP consists of publicly traded common units held by limited partners (LPs), a general partner (GP) interest, and IDRs. IDRs represent a separate class of nonvoting LP interest that the GP initially holds but may transfer or sell separately from its interest.

Generally, the partnership agreement obligates the GP to distribute all of the partnership's available cash<sup>6</sup> at the end of each quarter to the LPs, GP, and when certain thresholds are met, the IDR holders. These required cash distributions may or may not equal the MLP's earnings for the period.

At issue is whether, when applying the two-class method in computing earning per unit for MLPs, an IDR is a participating security pursuant to Statement 128<sup>7</sup> and Issue 03-6<sup>8</sup> because of the IDR holder's participation in required cash distributions and, if so, whether current-period earnings (or losses) should be allocated to IDR holders.

**SUMMARY:** The Task Force did not reach a conclusion about whether current-period earnings (or losses) should be allocated to IDR holders in computing earnings per unit.

**NEXT STEPS:** The FASB staff will prepare examples of the application of the two-class method for MLPs, including a scenario in which current-period required cash distributions exceed earnings, for consideration at the September 2007 EITF meeting.

<sup>6</sup> "Available cash" is typically defined in the partnership agreement as all cash on hand at the end of each quarter less cash retained by the partnership as capital to (1) operate the business (e.g., future capital expenditures); (2) comply with applicable law, debt, and other agreements; and (3) provide funds for distribution to the common unit, GP, and IDR holders for any one or more of the next four quarters.

<sup>7</sup> FASB Statement No. 128, *Earnings per Share*.

<sup>8</sup> EITF Issue No. 03-6, "Participating Securities and the Two-Class Method Under FASB Statement No. 128."

## D-Topics

The Securities and Exchange Commission (SEC) updated EITF Topic No. D-98, "Classification and Measurement of Redeemable Securities," as follows:

Topic D-98 has been modified because of the issuance of Statement 159.<sup>9</sup> Statement 159 permits an issuer to elect to carry certain financial assets and liabilities at fair value through earnings, but prohibits an issuer from electing the fair value option for financial instruments that are, in whole or in part, classified as a component of shareholders' equity (including "temporary equity"). The SEC has previously accepted liability classification for financial instruments (or host contracts) that meet the conditions for temporary equity classification under ASR 268 (FRR Section 211)<sup>10</sup> and Topic D-98. To eliminate any potential inconsistency between the scope of Statement 159 and this previously accepted practice, Topic D-98 will now indicate that the SEC staff will no longer accept liability classification for financial instruments (or host contracts) that meet the conditions for temporary equity classification under ASR 268 and Topic D-98. The SEC staff's position is that these financial instruments must be classified on the balance sheet between captions for liabilities and shareholders' equity and that these financial instruments are **not** eligible for the fair value option.

The SEC staff's position should be applied through either (1) prospective application for all affected financial instruments (or host contracts) that are entered into, modified, or otherwise subject to a remeasurement (new basis) event, beginning in the registrant's first fiscal quarter after September 15, 2007, or (2) retrospective application to financial reporting periods that ended before the date of initial adoption of the view, provided that Statement 154<sup>11</sup> is followed. Earlier adoption is allowed; however, previously issued financial statements should not be retrospectively adjusted. Registrants that choose prospective application (i.e., that continue their liability classification for preexisting financial instruments (or host contracts) that met the conditions for temporary equity classification) cannot apply the fair value option to those instruments (or hosts) upon adoption of Statement 159.

<sup>9</sup> FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*.

<sup>10</sup> SEC Accounting Series Release No. 268 (FRR Section 211), *Redeemable Preferred Stocks*.

<sup>11</sup> FASB Statement No. 154, *Accounting Changes and Error Corrections*.

## Subscriptions

If you wish to receive *EITF Snapshot*, as well as other accounting publications issued by the Accounting Standards and Communications Group of Deloitte & Touche, please [register](http://www.deloitte.com/us/subscriptions) at [www.deloitte.com/us/subscriptions](http://www.deloitte.com/us/subscriptions).

## *Dbriefs* for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte & Touche's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts presented each month on:

- Sarbanes-Oxley.
- Corporate governance.
- Private companies.
- Financial reporting.
- Driving enterprise value.
- Transactions and business events.

*Dbriefs* also provides a convenient and flexible way to earn CPE credit — right at your desk. [Join \*Dbriefs\*](#) to receive notifications about future webcasts at [www.deloitte.com/us/dbriefs](http://www.deloitte.com/us/dbriefs).

On June 19 at 2:00 PM EDT, we will host a 60-minute webcast, "EITF Roundup: Highlights of the June Meeting." [Register](#) for this webcast today.

## Technical Library: The Deloitte Accounting Research Tool Available

Deloitte & Touche makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, the EITF, the AICPA, the PCAOB, the IASB, and the SEC, in addition to Deloitte's own accounting manuals and other interpretive accounting guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. In addition, Technical Library subscribers receive *Technically Speaking*, the weekly publication that highlights recent additions to the library.

For more information, including subscription details and an online demonstration, visit [www.deloitte.com/us/techlibrary](http://www.deloitte.com/us/techlibrary).

### About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, its member firms, and their respective subsidiaries and affiliates. Deloitte Touche Tohmatsu is an organization of member firms around the world devoted to excellence in providing professional services and advice, focused on client service through a global strategy executed locally in nearly 140 countries. With access to the deep intellectual capital of approximately 135,000 people worldwide, Deloitte delivers services in four professional areas—audit, tax, consulting, and financial advisory services—and serves more than 80 percent of the world's largest companies, as well as large national enterprises, public institutions, locally important clients, and successful, fast-growing global growth companies. Services are not provided by the Deloitte Touche Tohmatsu Verein, and, for regulatory and other reasons, certain member firms do not provide services in all four professional areas.

As a Swiss Verein (association), neither Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each of the member firms is a separate and independent legal entity operating under the names "Deloitte," "Deloitte & Touche," "Deloitte Touche Tohmatsu," or other related names.

In the U.S., Deloitte & Touche USA LLP is the U.S. member firm of Deloitte Touche Tohmatsu, and services are provided by the subsidiaries of Deloitte & Touche USA LLP (Deloitte & Touche LLP, Deloitte Consulting LLP, Deloitte Financial Advisory Services LLP, Deloitte Tax LLP, and their subsidiaries) and not by Deloitte & Touche USA LLP. The subsidiaries of the U.S. member firm are among the nation's leading professional services firms, providing audit, tax, consulting, and financial advisory services through nearly 40,000 people in more than 90 cities. Known as employers of choice for innovative human resources programs, they are dedicated to helping their clients and their people excel. For more information, please visit the U.S. member firm's Web site at [www.deloitte.com/us](http://www.deloitte.com/us).