



EITF Reaches Three Tentative Conclusions

The FASB's Emerging Issues Task Force reached tentative conclusions that would affect accounting for debt that becomes convertible when the issuer exercises a call option, accounting for employees' rights to compensated sabbatical leaves, and disclosures about the seller's accounting for sales taxes.¹ If the tentative conclusions are ratified by the FASB, they will be issued for public comment and considered by the EITF at its next meeting to determine whether a consensus can be reached. The EITF also discussed accounting for payments made by service providers to manufacturers and resellers and the postretirement-benefit aspects of "split-dollar life insurance" arrangements.

Conversion Triggered by Call Option (EITF 05-1)

The conversion of a debt instrument that becomes convertible because the issuer calls the debt would be accounted for as a debt conversion rather than a debt extinguishment under the EITF's tentative conclusion if the instrument included a substantive conversion feature when it was issued. If the debt instrument does not contain a substantive conversion feature, the conversion would be recognized as a debt extinguishment.

Many convertible debt instruments, including the contingently convertible instruments described in EITF 04-8, contain provisions that permit the holder to convert the debt to equity securities if the issuer calls the debt.² EITF 05-1 addresses only situations in which the debt instrument is not otherwise convertible at the time the issuer calls the debt. Since the debt was not convertible prior to the issuer's exercise of the call, the question for the EITF was whether a conversion in that situation should be accounted for as a conversion or an extinguishment.

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¹ EITF Issue Nos. 05-1, Accounting for Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option; 06-2, Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, Accounting for Compensated Absences; and 06-3, How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (That is, Gross Versus Net Presentation).

² EITF Issue No. 04-8, The Effect of Contingently Convertible Instruments on Diluted Earnings per Share.

The determination of whether a debt instrument has one or more conversion features beyond the exercise of the issuer's call that are substantive is made as of its issuance date. The EITF agreed that the *issuance date* of the instrument would be the same as its commitment date, as defined in EITF 00-27.³ Although the determination would be made "as of" the date of issuance, the assessment need not be made contemporaneously with issuance.

The EITF also agreed that, for purposes of the tentative conclusion, a debt instrument's conversion feature is substantive if it is "reasonably possible" to become exercisable without being triggered by the issuer calling the debt. A conversion feature that can become exercisable only by the issuer calling the debt would not be a substantive conversion feature.

Some Task Force members observed that in determining whether a conversion feature is substantive, it would be appropriate to compare the interest rate on the convertible instrument as of the date of issuance with the interest rate that would be required if the instrument had no conversion features. The difference might indicate how the marketplace has assessed the likelihood of conversion. The FASB staff will include additional guidance on making this determination in the draft abstract that will be issued for public comment.

The final Consensus on EITF 05-1 is expected to be effective for conversions that occur as a result of the issuer's exercise of a call option in interim or annual periods beginning after the date the FASB ratifies a final Consensus, regardless of when the instrument was originally issued.

Accounting for Sabbatical Leave (EITF 06-2)

The EITF tentatively concluded that an employee's right to a compensated absence under a sabbatical or similar benefit arrangement in which the employee is not required to perform any duties during the absence "accumulates" and, therefore, should be accounted for as a liability if the other conditions for recognition in Statement 43 are met.⁴ The Statement requires accrual of a liability for employees' compensation for future absences over the service period if all these conditions are met:

- The employer's obligation is attributable to employees' services already rendered;
- The obligation relates to rights that vest or accumulate;
- Payment of the compensation is probable; and
- The amount can be reasonably estimated.

Under an example arrangement discussed by the EITF, an employee is eligible to take ten weeks off as a sabbatical leave after eight years of service. During the sabbatical, the employee continues to be compensated but is not required to perform any duties for the employer. The right to the compensated absence does not vest, because the employee is not entitled to payment for unused sabbatical leave upon termination of employment.

However, the Task Force concluded that the employer's obligation for the sabbatical accumulates and should be recognized as a liability. Sabbatical leaves that obligate the employee to perform research or other services during the sabbatical period are excluded from the scope of this Issue.

A liability for sabbatical leaves in accordance with a final Consensus would be recognized

as a change in accounting principle calling for retrospective application to all prior periods if practicable. The Consensus would be effective for the first annual reporting period beginning after the date of FASB's ratification.

Accounting Policy for Sales Taxes (EITF 06-3)

The EITF tentatively concluded that a company must adopt a policy of presenting externally imposed taxes on revenue-producing transactions on either a gross or net basis. Gross or net presentation may be elected for each different type of tax, but similar taxes should be presented consistently. Taxes within the scope of this Issue would include taxes that are imposed on a revenue transaction between a seller and a customer—for example, sales taxes, use taxes, value-added taxes, and some types of excise taxes.

If the taxes are significant, the company would be required to disclose the adopted policy in the notes to the financial statements. If significant taxes on revenue-producing transactions are presented gross, the company would also be required to disclose the amount presented on a gross basis. Under a final Consensus on EITF 06-3, the disclosures would be required in interim and annual financial periods beginning after December 15, 2006.

Payments Made by Service Providers (EITF 06-1)

The EITF discussed the accounting for cash or other consideration that providers of services that depend on specialized equipment pay to manufacturers or resellers of the specialized equipment.⁵ The services might, for example, be cable or satellite TV or radio services or security services. The payments may be incentives to reduce the selling price

³ EITF Issue No. 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments.

⁴ FASB Statement No. 43, Accounting for Compensated Absences, November 1980, available at www.fasb.org.

⁵ EITF Issue No. 06-1, Accounting for Consideration Given by a Service Provider to Manufacturers or Resellers of Specialized Equipment Necessary for an End-Customer to Receive a Service from the Service Provider.

of the specialized equipment in order to stimulate end-customer demand for the services. These types of incentives are common during the initial stage of a service's introduction to the market when the cost of the specialized equipment may be prohibitive to some end-customers. The incentives could be in the form of cash, equity instruments, technological know-how, key components of the specialized equipment, or tooling.

The Task Force discussed whether these types of incentive payments are within the scope of EITF 01-9 and, if so, how its Consensus would be applied.⁶ Part of the discussion focused on the degree of linkage between the incentive payment made by the service provider and the service provider's contract with the end-customer. The Task Force also considered whether to develop a new model, separate from EITF 01-9, for these arrangements. The Task Force plans to discuss this issue further at future meetings.

Postretirement Benefits Associated with Split-Dollar Life Insurance (EITF 06-4)

The EITF considered the accounting for the deferred-compensation or postretirement benefit aspects of an endorsement-type split-dollar life insurance arrangement.⁷ Companies purchase life insurance for various reasons that may include protecting against the loss of "key" employees, funding deferred-compensation and postretirement benefit arrangements, and providing investment returns.

In endorsement-type split-dollar life insur-

ance arrangements, the employer purchases a life insurance policy to insure the life of an employee and enters into a separate agreement that splits the policy's premiums and/or policy benefits between the employer and the employee. The employer owns and controls the policy, and the employee designates his/her beneficiary for the employee's portion of the death benefits.

The Task Force discussed whether an endorsement-type split-dollar life insurance arrangement "embodies" an obligation to the employee that should be recognized as a liability by the employer. The members also considered whether the purchase of the policy effectively settles any obligation and how the economic sacrifice of a portion of the death benefit, which would otherwise be retained by the employer, should be reflected in the financial statements. The Task Force plans to discuss the issue further at future meetings.

Other Matters

The SEC staff clarified the application of EITF D-98 to share-based-payment arrangements with employees, and the EITF considered some agenda items and agreed to modify the Consensus in EITF 05-7. The Task Force Chairman also announced changes in the EITF's operating procedures that became effective as of the March meeting.

SEC Staff Announcement on EITF D-98.

The SEC staff clarified its position on the application of EITF D-98 to share options or similar instruments granted in conjunction with share-based payment arrangements with

employees whose terms may permit redemption of the share option or underlying share.⁸ The staff believes that the initial amount classified outside of permanent equity should be based on the redemption provisions of the instrument. For example, upon issuance of a fully-vested share option that allows the holder to put the share option back to the issuer at its intrinsic value upon a change in control, the intrinsic value of the share option at the date of issuance would be its redemption amount and should be presented outside of permanent equity. The clarification also refers to other guidance in EITF D-98 that should be followed to determine the amount, if any, of subsequent adjustments to the redemption amount. The redemption amount for partially-vested awards is measured based on the proportionate amount of employee service rendered to date.

Agenda Items. The EITF added to its agenda Issue No. 06-D, "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." The Agenda Committee discussed "Transactions Involving the Purchase of Financial Assets and Simultaneous Repurchase of the Same Financial Assets with the Seller," but deferred making a decision on whether to add that issue to the EITF agenda until the FASB decides whether to provide guidance on the subject.

Consensus Modification (EITF 05-7). The Task Force agreed to clarify that the

⁶ EITF Issue No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*.

⁷ EITF Issue No. 06-4, *Accounting for the Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*.

⁸ EITF Topic No. D-98, *Classification and Measurement of Redeemable Securities*. The accounting for these arrangements was previously discussed in KPMG's *Defining Issues* No. 06-3, *Revised Statement 123R Classification Requirements for Contingently Cash-Settleable Share Options and Related Guidance for Public Companies*.



This is a publication of KPMG's
Department of Professional
Practice—Audit and Risk Advisory
212-909-5600

Contributing authors:

Mark M. Bielstein
Landon B. Westerlund
Robert B. Malhotra
Brian C. Stevens

Earlier editions are available at:
www.aro.kpmg.com

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Consensus in EITF 05-7 on accounting for modifications to conversion options embedded in debt securities also applies to a modification of a debt instrument that either adds or eliminates an embedded conversion option.⁹ The EITF 05-7 Consensus arrived at during the September 2005 EITF meeting requires an issuer, upon modification of a convertible debt instrument, to include the change in fair value of the related embedded conversion option in the analysis to determine whether a debt instrument has been extinguished pursuant to EITF 96-19.¹⁰ However, the Task Force observed that EITF 05-7 provides no guidance on how to apply EITF 96-19 to modifications of debt instruments that add or eliminate embedded conversion options that are required to be bifurcated from their hosts under Statement 133.¹¹

Operating Procedures. The EITF's operating procedures are modified as of the March 2006 meeting. The changes include the following:

- Prior to reaching a Consensus on an Issue, a tentative conclusion must be established and a draft abstract based on that tentative conclusion must be issued for public comment with a minimum 15-day comment period.
- Prior to issuing the draft abstract for public comment, the FASB must ratify the tentative conclusion and approve its exposure for public comment.
- The Task Force is to consider comments on each draft abstract at a future EITF meeting before determining whether to approve the tentative conclusion as a Consensus.

All final EITF Consensuses will continue to be subject to ratification by the FASB at a public meeting held prior to the distribution of the final EITF minutes. An EITF abstract is not considered part of the GAAP hierarchy until the final Consensus is ratified by the Board.¹²



The Task Force is expected to consider public comments on the tentative conclusions described above at the June 14-15, 2006 EITF meeting to determine whether to approve the tentative conclusions as final Consensuses.

The descriptive and summary statements above are not intended to be a substitute for the text of the EITF's Consensuses, tentative conclusions, or official minutes; FASB Statements; SEC staff announcements; or any of the other potential or actual requirements. Nor are any of the cited documents necessarily applicable to any entity's specific circumstances. In determining the appropriate accounting treatment for a transaction, one should refer to the texts of the applicable documents that set out requirements, including the formal EITF meeting minutes that will be made available on the FASB Web site, and consult their accounting and legal advisors.

⁹ EITF Issue No. 05-7, *Accounting for Modifications to Conversion Options Embedded in Debt Securities and Related Issues*.

¹⁰ EITF Issue No. 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments*.

¹¹ FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, June 1998, available at www.fasb.org.

¹² The Task Force's operating procedures are available on the FASB website at www.fasb.org/eitf/eitf_operating_procedures.pdf.