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## EITF Approves Three Consensuses

The FASB's Emerging Issues Task Force approved three Consensuses and reached four tentative conclusions at its meeting last week. If ratified by the FASB, the Consensuses would apply to service providers' payments to manufacturers and resellers of equipment needed to use the services, the postretirement-benefit obligation for "split-dollar life insurance" arrangements, and the asset recognized for purchases of life insurance.<sup>1</sup> The tentative conclusions would apply to modifications of convertible debt, conversion options previously separated from convertible debt that no longer meet the separation criteria, the sale of individual units in condominium projects, and reporting a change in differences between a parent's fiscal year-end and the fiscal year-end of its consolidated subsidiary or equity-method investee.<sup>2</sup>

If the FASB ratifies the Consensuses at its September 20, 2006 meeting as expected, they will become authoritative GAAP. FASB-ratified tentative conclusions from this meeting are expected to be issued for a 30-day comment period.

### Service Providers' Payments to Third Parties (EITF 06-1)

The EITF reached a Consensus on how providers of services that depend on specialized equipment should account for payments they make to the manufacturers or resellers of the specialized equipment. The service provider's objective is to stimulate demand for its services by facilitating equipment sales to potential customers. TV, radio, and security services are among those that might depend on specialized equipment often sold by unrelated manufac-

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<sup>1</sup> EITF Issue Nos. 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; 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements; and 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*. Tentative conclusions on these Issues had been exposed for public comment following the June EITF meeting. After considering comments received, the EITF finalized the Consensuses on these Issues, with limited modifications from the tentative conclusions.

<sup>2</sup> EITF Issue Nos. 06-6, Debtor's Accounting for a Modification (or Exchange) of Convertible Debt Instruments; 06-7, Issuer's Accounting for a Previously-Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*; 06-8, Applicability of the Assessment of a Buyer's Continuing Investment under FASB Statement No. 66, *Accounting for Sales of Real Estate*, for Sales of Condominiums; and 06-9, Reporting a Change in (or the Elimination of) a Previously Existing Difference between the Fiscal Year-End of a Parent Company and That of a Consolidated Subsidiary or an Equity Method Investee.

turers, and the payments could be in the form of cash, equity instruments, tooling, technological know-how, or key components of the specialized equipment.

The Consensus would require a service provider to characterize the consideration based on the form of the benefit the service provider's customer receives from the manufacturer or reseller. If the benefit is "other than cash" (such as a discount on the price of the equipment) or the service provider does not control the form of benefit given by the manufacturer or equipment seller to the customer, the consideration would be treated as a cost rather than as a reduction of revenue. If the contractual provisions dictate that the service provider's customer receives cash consideration, such as a cash rebate, the amount would be reported as a reduction of revenue.

If the Consensus is ratified, its requirements will have to be adopted through retrospective application to all prior periods as of the beginning of the first annual reporting period beginning after June 15, 2007, unless retrospective application is impracticable. Earlier adoption will be permitted for financial statements that have not yet been issued.

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

This Consensus addresses only *endorsement* split-dollar life insurance arrangements that provide a benefit to an employee that extends to postretirement periods. In an endorsement split-dollar arrangement, the employer owns and controls the policy, and the employer and an employee split the insurance policy's cash surrender value and/or death benefits.

The EITF Consensus would require that the deferred-compensation or postretirement

benefit aspects of an endorsement-type split-dollar life insurance arrangement be recognized as a liability by the employer and that the obligation is not effectively settled by the purchase of a life insurance policy. The liability for future benefits would be recognized based on the substantive agreement with the employee, which may be either to provide a future death benefit or to pay for the future cost of the life insurance. The FASB staff will provide guidance on determining the substance of the benefit arrangements that will be included in the final Consensus.

If ratified, the Consensus will be effective for fiscal years beginning after December 15, 2007. Early adoption will be permitted as of the beginning of an entity's fiscal year. Entities adopting the Consensus would choose between retrospective application to all prior periods or treating the application of the Consensus as a cumulative-effect adjustment to beginning retained earnings or to other components of equity or net assets in the statement of financial position.

### **Purchases of Life Insurance (EITF 06-5)**

This Consensus explains how to determine "the amount that could be realized" from a life insurance contract, which is the measurement amount for the asset in accordance with Technical Bulletin 85-4.<sup>3</sup> The Consensus would require policyholders to determine the amount that could be realized under a life insurance contract assuming individual policies are surrendered. The policyholder would not be permitted to assume that all policies will be surrendered simultaneously unless surrender is permitted only if all of the individual-life policies or certificates are surrendered as a group. All amounts that would ultimately be realized by the policyholder

upon the assumed surrender of the final policy would be included in the amount that could be realized under the insurance contract. Contractual provisions that limit the amount that could be realized in specified circumstances would be considered if it is probable that those circumstances would occur. Amounts recoverable by the policyholder at the discretion of the insurance company would be excluded from the amount that could be realized.

The Consensus would prohibit discounting the cash surrender value of contracts that restrict the policyholder's ability to surrender the life insurance policy if the policy will continue to increase in value in accordance with its terms during the period between the reporting date and the date the contractual prohibition is lifted. However, if the company surrendering the policy will receive a fixed amount only after a significant delay, the amount to be received should be discounted to its present value in accordance with Opinion 21.<sup>4</sup>

If ratified, the Consensus will be effective for fiscal years beginning after December 15, 2006. Earlier adoption will be permitted as of the beginning of a fiscal year for periods in which interim or annual financial statements have not yet been issued. Policyholders adopting the Consensus would choose between retrospective application to all prior periods or recognizing the adoption of the Consensus as a cumulative-effect adjustment to beginning retained earnings or to other components of equity or net assets.

### **Modifications of Convertible Debt (EITF 06-6)**

The EITF reached a tentative conclusion to revise the Consensus in EITF 05-7 by requiring that the change in the fair value of an embedded conversion option when convertible

<sup>3</sup> FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*, November 1985, available at [www.fasb.org](http://www.fasb.org)

<sup>4</sup> APB Opinion No. 21, *Interest on Receivables and Payables*, August 1971.

debt instruments are modified or exchanged should *not* be included in the cash flow analysis performed under EITF 96-19 to determine whether debt has been extinguished.<sup>5</sup> However, if the cash flow analysis indicates that the modification is not substantial, a separate, additional analysis of the change in the fair value of the conversion option should be performed. If the change in an embedded conversion option's fair value is found to be at least 10 percent of the debt instrument's carrying value immediately prior to the modification, the issuer should apply extinguishment accounting. The tentative conclusion would also require that a modification that either adds or eliminates a substantive conversion option always be treated as an extinguishment.

The EITF also tentatively concluded that when a debt instrument is modified or exchanged in a transaction that is not accounted for as an extinguishment, an increase in the fair value of an embedded conversion option caused by the modification should reduce the carrying amount of the debt instrument, with a corresponding increase in additional paid-in capital. However, a decrease in the fair value of an embedded conversion option resulting from a modification or exchange should not be recognized.

If a final Consensus is reached and ratified by the FASB, it will replace the current guidance in EITF 05-7. The conclusions in EITF 06-6 would apply to future modifications or exchanges of debt instruments that occur in the first interim or annual reporting period beginning after ratification. Early application would be permitted for modifications or exchanges of debt instruments in periods

for which financial statements have not yet been issued. The existing requirements in EITF 96-19 and EITF 05-7 will continue to be effective unless a final, ratified EITF 06-6 Consensus changes those requirements.

### **Previously Separated Conversion Options in Convertible Debt (EITF 06-7)**

The EITF reached a tentative conclusion on how to account for an embedded conversion option that was previously separated from a convertible-debt contract under the requirements of Statement 133 and EITF 00-19, but no longer meets Statement 133's requirements for separate accounting.<sup>6</sup> This situation might arise, for example, if a company issues a complex convertible debt instrument and has too few authorized, unissued common shares available to satisfy the potential conversion. If the number of authorized but unissued shares subsequently increases, the conversion feature may no longer be required to be separated from the debt instrument.

The EITF tentatively concluded that companies should reclassify to shareholder's equity the carrying value of a previously separated conversion option when it is no longer required to be separately accounted for. The debt discount recorded at issuance should continue to be amortized over the remaining term of the instrument. The EITF agreed that the issuer should disclose the changes causing the embedded conversion option to no longer qualify for separate accounting and the amount of the liability for the conversion option that was reclassified to equity.

Assuming FASB ratification in its current form, the tentative conclusion would apply

prospectively in interim and annual periods to all conversion options separated from convertible debt instruments beginning after December 15, 2006, regardless of whether the debt instrument was entered into prior to the Consensus's effective date. Early application will be permitted in periods for which financial statements have not yet been issued. Alternatively, an entity would be permitted to apply the Consensus by retrospective application to all prior periods.

### **Sales of Condominiums (EITF 06-8)**

The EITF tentatively concluded that the continuing-investment criterion in Statement 66 must be met to recognize profit on a percentage-of-completion basis for condominium sales.<sup>7</sup> Statement 66 requires a condominium developer to recognize profit from the sale of individual condominiums during the construction phase on a percentage-of-completion basis if specified criteria are met, including collectibility of the sales price. The tentative conclusion would require a developer to evaluate a buyer's continuing investment during the construction period and to conclude that the condominium's sales price was collectible before recognizing profit during the construction period.

If adopted as a ratified Consensus, this tentative conclusion would be effective for the first annual-reporting period beginning after March 15, 2007. Early adoption would be permitted as of the beginning of an entity's fiscal year. Entities that have not accounted for sales of condominiums in a manner that is consistent with the Consensus would recognize a cumulative-effect adjustment to beginning retained earnings or to other components of equity or net assets.

<sup>5</sup> EITF Issue Nos. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments, and 05-7, Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues, available at [www.fasb.org](http://www.fasb.org).

<sup>6</sup> FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998, and EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, available at [www.fasb.org](http://www.fasb.org).

<sup>7</sup> FASB Statement No. 66, Accounting for Sales of Real Estate, October 1982, available at [www.fasb.org](http://www.fasb.org).



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### Change in Subsidiary's Fiscal Year-End (EITF 06-9)

The EITF addressed how a company should report a change in or the elimination of a difference between a parent company's fiscal year-end and the fiscal year-end of a consolidated subsidiary or equity-method investee (referred to as a lag period). Consider the case of a parent company with a December 31 year-end that has historically consolidated a subsidiary based on the subsidiary's November 30 fiscal year-end. The subsidiary later changes its year-end to December 31. The question is how the parent company should recognize the effect of the elimination of the one-month lag in recognizing the subsidiary's operations in the consolidated financial statements.

The EITF tentatively concluded that the parent company should recognize the effect of a change in the difference between the parent's reporting period and the reporting period of a consolidated subsidiary or equity-method investee as a change in accounting principle through retrospective application to all prior periods, unless that approach would be impracticable. If it is impracticable for all prior periods, the effect of the change should be recognized as a cumulative-effect adjustment to beginning retained earnings in the earliest period to which the new accounting principle can be applied. The EITF observed that retrospective application may be impracticable in some situations.

If adopted as a final Consensus, this tentative conclusion would be effective for changes in a lag period beginning in the first interim or annual period following Board ratification. Earlier application would be permitted in periods for which financial statements have not yet been issued.

### Administrative Matters

The EITF added to its agenda EITF 06-H, which will address the application of the AICPA Audit and Accounting Guide for Brokers and Dealers in Securities to entities that engage in commodity trading activities. It also added EITF 06-I, which will address joint development, manufacturing, and marketing arrangements.<sup>8</sup> The Task Force removed from its agenda EITF 03-17, on the subsequent accounting for executory contracts that have been recognized on an entity's balance sheet.<sup>9</sup>



The EITF is expected to consider public comments on the tentative conclusions described above at its November 15-16, 2006 meeting and to determine whether to approve the tentative conclusions as Consensuses.

The descriptive and summary statements above are not intended to be a substitute for the texts of the EITF's Consensuses, tentative conclusions, or official minutes or any other potential or actual requirements. In determining the appropriate accounting treatment for a transaction, companies 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, consider the specific circumstances, and consult their accounting and legal advisors.

<sup>8</sup> EITF Issue Nos. 06-H, Application of the AICPA Audit and Accounting Guide, Brokers and Dealers in Securities, to Entities That Engage in Commodity Trading Activities; and 06-I, Accounting for Joint Development, Manufacturing, and Marketing Arrangements in the Biotechnology and Pharmaceutical Industries.

<sup>9</sup> EITF Issue No. 03-17, Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity's Balance Sheet.