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EITF Approves Three Consensuses

The FASB's Emerging Issues Task Force approved three Consensuses and reached three tentative conclusions. The Consensuses would apply to debt that becomes convertible when the issuer exercises a call option, employees' rights to compensated sabbatical leaves, and sales taxes.¹ The tentative conclusions would apply to payments made by service providers to manufacturers and resellers, the postretirement-benefit obligation for "split-dollar life insurance" arrangements, and the amount of the asset that would be recognized for purchases of life insurance.² The EITF also discussed accounting for modifications to conversion options embedded in debt instruments.³

If the FASB ratifies the Consensuses at its June 28, 2006 meeting, they will become authoritative GAAP. FASB-ratified tentative conclusions from this meeting are expected to be issued for a 30-day comment period.

Conversion Triggered by Call Option (EITF 05-1)

EITF 05-1 pertains only to debt instruments that become convertible at the time the issuer calls the debt, but are not convertible before the call is exercised. Conversions of these instruments triggered by the call option would be accounted for as debt conversions under the

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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 Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation). Tentative conclusions on these Issues had been exposed for public comment following the March EITF meeting. After considering comments received, the EITF approved the Consensuses on these Issues, with limited modifications from the tentative conclusions.

² 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 Purchase of Life Insurance*.

³ EITF Issue No. 05-7, Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues.

Consensus if the instrument included a substantive conversion feature other than the call option when it was issued. The conversions would be recognized as debt extinguishments if the debt instrument did not contain a substantive conversion feature at issuance.

Companies would determine whether a debt instrument has a substantive conversion feature as of the instrument's issuance date.

However, the determination need not be made when the instrument is issued. For purposes of the Consensus, the instrument's issuance date would be the same as its commitment date as defined in EITF 00-27.⁴

A debt instrument's conversion feature is substantive, according to the Consensus, if it is "reasonably possible" that it will be exercised without being triggered by the issuer calling the debt. A conversion feature that can be exercised only if the issuer calls the debt would not be a substantive conversion feature.

The published Consensus will contain examples of methods to determine whether a conversion feature is substantive.

The Consensus will 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 of FASB ratification.

Accounting for Sabbatical Leave (EITF 06-2)

The EITF reached a Consensus that an employee's right to a compensated absence under a sabbatical or similar benefit arrange-

ment 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.⁵ The other conditions in Statement 43 are that the obligation relates to services already rendered, payment is probable, and the amount can be reasonably estimated.

For example, an employee is eligible to take ten weeks of sabbatical leave after eight years of service. The employee continues to be compensated during the sabbatical, but is not required to perform any duties. The right to the compensated absence does not vest, because the employee is not entitled to payment for unused sabbatical when employment terminates. However, the employer's obligation for the sabbatical "accumulates," and therefore, assuming the other conditions of Statement 43 are met, the compensation cost for the sabbatical should be recognized as a liability over the required eight-year service period.

Sabbatical leave arrangements that obligate the employee to perform research or otherwise benefit the employer during the sabbatical period are excluded from the scope of this Consensus. The Consensus also does not address how to measure the liability.

A liability for sabbatical leaves recorded in accordance with this Consensus would be recognized as a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. However, retrospective

application to all prior periods would also be permitted. If ratified, the Consensus will be effective for fiscal years beginning after December 15, 2006 with early application permitted, provided the entity has not issued any financial statements for any period of the earlier fiscal year.

Accounting Policy for Sales Taxes (EITF 06-3)

Consensus 06-3 would permit companies to elect to present on either a gross or net basis sales and other taxes that are imposed on and concurrent with individual revenue-producing transactions between a seller and a customer. The gross basis includes the taxes in revenues and costs; the net basis excludes the taxes from revenues. The Consensus would not apply to tax systems that are based on gross receipts or total revenues.

Companies would disclose their policy for presenting the taxes and would disclose any amounts presented on a gross basis.

Companies would not be required by the Consensus to change their policies for presenting taxes. A change would be permitted only if the new policy is considered preferable.

Assuming ratification, the disclosures required by the Consensus will have to be presented for interim and annual financial periods beginning after December 15, 2006.

Payments Made by Service Providers (EITF 06-1)

The EITF reached a tentative conclusion on accounting for payments of cash and other consideration by providers of services that

⁴ EITF Issue No. 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments.

⁵ FASB Statement No. 43, Accounting for Compensated Absences, November 1980, available at www.fasb.org.

depend on specialized equipment to the manufacturers or resellers of the specialized equipment. TV, radio, and security services are among those that might depend on specialized equipment. The payments could be incentives to reduce the selling price of the equipment in order to stimulate end-customer demand for the services. The payments could be in the form of cash, equity instruments, tooling, technological know-how, or key components of the specialized equipment.

The Task Force tentatively concluded that a service provider should characterize the consideration based on the form of the benefit the service provider's customer receives from the manufacturer or reseller. If the benefit provided by the manufacturer or reseller to the service provider's customer 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 reseller to the end-customer, the consideration the service provider gives the manufacturer or reseller would not be presented as a reduction in revenue. If the service provider's customer receives cash as directed by the service provider, the consideration given by the service provider to the manufacturer or reseller would be presented by the service provider as a reduction of revenue.

The potential Consensus would be effective for the first annual reporting period beginning after June 15, 2007. Early adoption would be permitted as of the beginning of the company's fiscal year. Applying the guidance would be treated as a change in

accounting principle through retrospective application to all prior periods.

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

The EITF tentatively concluded that the deferred-compensation or postretirement benefit aspects of an endorsement-type split-dollar life insurance arrangement should be recognized as a liability by the employer and that the obligation is not effectively settled by the purchase of a life insurance policy.

If adopted as a ratified Consensus, this tentative conclusion could significantly change some companies' current practices. The tentative conclusion would be effective for fiscal years beginning after December 15, 2006. The effect of initially applying the guidance would be accounted for in a manner similar to a cumulative-effect-type adjustment. Alternatively, companies would be permitted to apply the Consensus retrospectively to all prior periods.

Purchases of Life Insurance (EITF 06-5)

The EITF tentatively concluded that a policyholder should consider any additional amounts included in the contractual terms of the life insurance policy in determining the "amount that could be realized under the insurance contract."⁶ For group policies with multiple certificates or multiple policies with a group rider, the Task Force also tentatively concluded that the amount that could be realized should be determined on the individual-policy or certificate level. Amounts that

would be realized only by surrendering all of the policies or certificates would not be included when measuring the assets.

The tentative conclusion would be effective for periods beginning after December 15, 2006, and would be applied by recognizing a cumulative-effect adjustment at the date of adoption for all life insurance contracts currently held. Alternatively, retrospective application would be permitted.

Conversion Options Embedded in Debt Instruments (EITF 05-7)

The EITF considered accounting for modifications to conversion options embedded in debt instruments that are not required to be bifurcated from the host contract and accounted for at fair value under Statement 133.⁷ The Task Force revisited the existing Consensuses on EITF 05-7 and discussed how a change in terms should be evaluated to determine whether a debt instrument has been extinguished. It also discussed whether evaluating the significance of a change in the terms of a conversion option should be separate from analyzing whether a modification has occurred as required under EITF 96-19.⁸

The existing Consensuses on EITF 05-7 continue to apply until any changes are made by the EITF.

Agenda Matters

The Task Force removed EITF 04-7, on identifying a variable interest in a potential variable-interest entity, from its agenda, because that issue has been addressed by FASB Staff

⁶ FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance, available at www.fasb.org.

⁷ FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998, available at www.fasb.org.

⁸ EITF Issue No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments.



Position FIN 46(R)-6.⁹ The Task Force added to its agenda EITF 06-E, on previously-bifurcated conversion options in convertible debt that no longer meet the bifurcation criteria in paragraph 12 of Statement 133.¹⁰



The Task Force is expected to consider public comments on the tentative conclusions described above at the September 6-7, 2006 EITF meeting and to determine whether to approve them as final 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.

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⁹ EITF Issue No. 04-7, Determining Whether an Interest is a Variable Interest in a Potential Variable Interest Entity; FASB Staff Position FIN 46(R)-6, Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R), available at www.fasb.org.

¹⁰ EITF Issue No. 06-E, 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 Investments and Hedging Activities."