

EITF Update

EITF meeting highlights

Emerging Issues Task Force

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19 November 2009 meeting highlights

The EITF reached a **final consensus** on the following Issue:

- ▶ Issue 09-E – Accounting for Stock Dividends, Including Distributions to Shareholders with Components of Stock and Cash

Contrary to the proposed amendments in the consensus-for-exposure, the EITF concluded in the final consensus that the dividends in question should be accounted for as a stock issuance, rather than a stock dividend that requires retroactive restatement of earnings per share. This final consensus is subject to ratification as an Accounting Standards Update by the FASB at its 2 December 2009 meeting.

The EITF reached a **consensus-for-exposure** on the following Issues:

- ▶ Issue 09-F – Casino Base Jackpot Liabilities
- ▶ Issue 09-G – Clarification of the Definition of Deferred Acquisition Costs of Insurance Entities
- ▶ Issue 09-I – Effect of a Loan Modification When the Loan Is Part of a Pool that is Accounted for as a Single Asset
- ▶ Issue 09-J – Impact of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in which the Underlying Equity Security Primarily Trades

The above Issues, if ratified as consensuses-for-exposure by the FASB at its 2 December 2009 meeting, will be exposed for comment and are subject to approval as final consensuses by the EITF at its 18 March 2010 meeting. While three of the above consensuses-for-exposure are generally consistent with the predominant current practice, **the consensus-for-exposure in Issue 09-G would represent a significant change in current practice for insurance enterprises.**

The EITF also discussed Issue 09-2 -Research and Development Assets Acquired and Contingent Consideration Issued in an Asset Acquisition, but was unable to reach a consensus and does not expect to further discuss this Issue.

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The consensuses to be exposed by the EITF are not always clearly articulated at the EITF meeting and such conclusions, if ratified by the FASB, are subject to a 30-day comment period and must be subsequently affirmed by the EITF as a final consensus and again ratified by the FASB. Accordingly, this summary should not be relied on exclusively in making a determination about the appropriate accounting for a transaction. The final EITF minutes will be made available as soon as they are published by the FASB in GAAIT-see U.S. Accounting and Auditing-EITF-Latest Updates.

Final consensus

Issue 09-E – Accounting for Stock Dividends, Including Distributions to Shareholders with Components of Stock and Cash

Issue

ASC 260¹ establishes guidance for computing and presenting earnings per share (EPS) and applies to entities with publicly-held common stock or potential common stock. ASC 260-10-55-12 states that if the number of common shares outstanding increases as a result of a stock dividend, the computations of basic and diluted EPS should be adjusted retroactively for all periods presented to reflect that change in capital structure.

ASC 505-20-05-3² states that after a stock dividend “the proportional interest of each shareholder remains the same.” Further, ASC 505-20-15-3(d) indicates that transactions “in which each shareholder is given an election to receive cash or shares” are not in the scope of ASC 505-20.

Real Estate Investment Trusts (REITs) are required to distribute 90 percent of their taxable income in accordance with US tax regulations. In certain circumstances, REITs may satisfy these distribution requirements in cash and stock. Shareholders elect the form of their distribution, subject to a minimum (and generally a maximum) amount of the distribution to be paid in cash.

The issue is whether or not the stock portion of a distribution to shareholders that contains components of cash and stock and allows shareholders to select their preferred form of the distribution should be accounted for as a stock dividend for EPS purposes.

The EITF reached a final consensus on Issue 09-E, which is subject to ratification by the FASB at its 2 December 2009 meeting.

In the final consensus, the EITF did not reaffirm the views presented in the consensus-for-exposure. The consensus-for-exposure proposed that a distribution that contains components of cash and stock and allows shareholders to select their preferred form of distribution is a stock dividend. Rather, the EITF reached a final consensus in favor of the alternative view presented in the Proposed Accounting Standards Update (ASU) that such a distribution should be treated as a stock issuance. This conclusion is based on the guidance in ASC 505 that states that a distribution of stock is considered a stock dividend only to the extent that all shareholders receive a proportionate distribution of stock such that their ownership interests after the distribution remain unchanged.

The ASU will amend the language in ASC 505-20-15-3 to clarify that distributions to shareholders with components of stock and cash when there is a potential limitation on the amount of cash to be distributed are not subject to the stock dividend guidance. The ASU Summary will include a reminder to the readers that an unconditional obligation that the issuer must or may settle by delivering a variable number of shares (i.e., the distribution) or cash with a fixed monetary amount should be considered a liability pursuant to ASC 480-10³ and would be included in dilutive EPS pursuant to ASC 260-10-45-45 through 45-46 until the liability is settled.

The EITF decided not to provide guidance on when a stock dividend should be reflected in EPS. We believe that a stock dividend should be reflected in EPS when the trading price of the shares has been adjusted to reflect the effects of the stock dividend (i.e., when the shares are traded without the rights to the dividends).

¹ ASC 260, *Earnings Per Share* (formerly, FASB Statement No. 128, *Earnings per Share*)

² ASC 505-20, *Equity- Stock Dividends and Stock Splits* (formerly, Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*)

³ ASC 480-10, *Distinguishing Liabilities from Equity-Overall* (formerly, FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*)

Implications

There is currently diversity in practice among REITs as to whether the stock portions of these stock and cash distributions are considered stock dividends for the purpose of determining EPS. The final consensus eliminates that diversity. Those entities that previously accounted for such dividends as stock dividends and retroactively restated EPS will have a very short period to recalculate and restate those EPS amounts upon adoption of the final ASU. Accordingly, those entities should begin performing those recalculations soon.

While these dividend structures are most common among REITs due to their distribution requirements under US tax regulations, the scope of this issue is not limited to REITs. This issue also affects other entities that make similar distributions.

Effective Date and Transition

If ratified at the 2 December 2009 FASB meeting, the ASU will be effective for interim and annual periods ending on or after 15 December 2009. The ASU will require retrospective application.

Consensuses-for-exposure

Issue 09-F – Casino Base Jackpot Liabilities

Issue

ASC 924⁴ provides guidance on accounting and financial reporting matters specific to the gaming industry.

In most gaming jurisdictions, gaming entities are not required to retain and award the base amount of a jackpot, which is funded by the entity, when machines are removed from the gaming floor. Thus, if a machine is removed before the jackpot has been won, it is possible that the base jackpot amount will not be awarded.

Under CON 6,⁵ a liability is not recognized prior to the occurrence of transactions or events creating an obligation for the future sacrifice of economic benefits. However, ASC 924-605-25-2 requires revenue to be charged ratably for the base jackpot over the period of play expected to precede payout. Therefore, it is unclear whether the base jackpot represents a cost of revenue that should be matched to the period in which revenue is generated and accrued as a liability.

The EITF reached a consensus-for-exposure on Issue 09-F.

The EITF reached a consensus-for-exposure that gaming entities should not accrue a liability for base jackpots prior to being won because the base jackpot does not represent a present obligation to transfer assets as a result of a past event (i.e., it does not meet the definition of a liability in CON 6). Therefore, the guidance in this Issue only would require a gaming entity to record a liability for the base jackpot at the time that jackpot is won. In most jurisdictions, the gaming entity has the ability to avoid payment of the base jackpot provided the jackpot is not yet won by a player. This consensus-for-exposure would not apply to the extent a gaming entity is unable to avoid payment of the base jackpot (due to the legal requirements of its gaming jurisdiction). In those circumstances, the base jackpot would most likely be ratably accrued over the period of play expected to precede payout.

Implications

We believe that the proposed guidance on accounting for casino base jackpot liabilities generally will validate the method commonly applied in practice. Accordingly, we expect minimal change in practice as a result of this consensus, if affirmed.

Effective Date and Transition

If affirmed, the consensus-for-exposure will be effective for fiscal years, and interim periods within those fiscal years, beginning on or after 15 December 2010. The consensus-for-exposure will be adopted through a cumulative effect adjustment to the opening balance of retained earnings as of the beginning of the fiscal year in which the Issue is initially applied.

⁴ ASC 924, *Entertainment – Casinos* (formerly, AICPA Audit & Accounting Guide AAG-CAS, *Casinos*)

⁵ FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*

Issue 09-G – Clarification of the Definition of Deferred Acquisition Costs of Insurance Entities

Issue

Insurance entities capitalize and amortize certain costs related to the acquisition of new or renewal contracts. Under ASC 944-30,⁶ these deferred acquisition costs may only be capitalized if they “vary with and are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred.”

The definitions of “vary” and “primarily related” are unclear as to which costs they relate (e.g., whether it is appropriate to include advertising costs incurred during a period) and, as a result, diversity in practice has developed around whether certain costs should be capitalized.

The EITF reached a consensus-for-exposure on Issue 09-I, which would represent a significant change in practice for most insurance companies.

Under the consensus-for-exposure, acquisition costs would be interpreted as those costs that are “directly related” to the successful acquisition of new and renewal insurance contracts. The EITF concluded that a direct cost notion is consistent with current US GAAP for comparable transactions (e.g., ASC 310-20⁷ involving loan origination costs). While the guidance in ASC 310-20 is limited to loan origination or acquisition activities, the EITF concluded that the concepts in that guidance are helpful in understanding the nature of insurance costs that may be capitalized. We expect that the consensus-for-exposure will have language similar to that in ASC 310-20, conformed to apply to insurance activities.

Accordingly, a successful efforts method would be applied in determining whether acquisition costs may be capitalized. Examples of costs that are “directly related” to that acquisition that may be eligible to be capitalized include, but are not limited to:

- ▶ Commissions paid to selling agents, agents who write the business, and brokers
- ▶ Bonuses paid to agents or brokers that vary with production
- ▶ Policy preparation costs (assembly and mailing of new policy material)
- ▶ Portions of salaries and benefits for agents, underwriters and secretarial assistance and clerical support to underwriting staff directly related to time spent performing those activities that would not have been incurred but for that successful contract acquisition

Additionally, the EITF concluded that indirect costs would not qualify as acquisition costs that may be capitalized. For example, advertising costs would not meet the definition of acquisitions costs and could not be capitalized unless permitted by other guidance; i.e., ASC 340-20,⁸ which provides specific guidance for situations in which capitalization of advertising costs may be appropriate (such as in the case of direct-response advertising).

⁶ ASC 944-30, *Financial Services – Insurance – Acquisition Costs* (formerly, FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* and FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*)

⁷ ASC 310-20, *Receivables- Nonrefundable Fees and Other Costs* (formerly, FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Origination or Acquiring Loans and Indirect Costs of Leases*)

⁸ ASC 340-20, *Other Assets and Deferred Costs – Capitalized Advertising Costs* (formerly, AICPA Statement of Position 93-7, *Reporting on Advertising Costs*)

The EITF tentatively concluded to amend the disclosures required by ASC 944-30-50-1 to include disclosure of both the nature and type of acquisition costs capitalized.

Implications

Currently acquisition costs include those costs that “vary with and are primarily related to” the acquisition of insurance contracts. Additionally, the threshold for capitalization has not been interpreted to allow only the costs associated with successful efforts. The EITF consensus-for-exposure, if ultimately affirmed by the EITF and ratified by the FASB (which would occur no earlier than March 2010), will likely represent a significant change for most insurance companies and require significant effort to implement.

Effective date and transition

If affirmed, the consensus-for-exposure will be effective for fiscal years, and interim periods within those fiscal years, beginning on or after 15 December 2010, through prospective application. Retrospective application also will be allowed. Early adoption will be permitted.

Issue 09-I – Effect of a Loan Modification When the Loan Is Part of a Pool that is Accounted for as a Single Asset

Issue

Recently, there has been an increase in the number of loans acquired in a transfer for which there is evidence of deterioration of credit quality such that it is probable at acquisition that the investor will be unable to collect all contractually required payments. When an entity acquires loans with deteriorated credit quality, ASC 310-30⁹ allows for loans with “common risk characteristics” to be accounted for in the aggregate as a single pooled asset.

At issue is whether the troubled debt restructuring (TDR) criteria in ASC 310-40¹⁰ should be applied to modifications of individual loans within a pool. Additionally, if the loan modification is a troubled debt restructuring, the issue is whether the modified loan should be removed from the pool and accounted for as an impaired loan under ASC 310-10¹¹ or whether the guidance in ASC 310-30-40-1 should be applied, which states that a pool, once assembled, must be maintained.

The EITF reached a consensus-for-exposure on Issue 09-I.

Under the consensus-for-exposure, the guidance in ASC 310-40-15-4 through 15-12 (i.e., TDR accounting) would not be applied to acquired loans with deteriorated credit quality that are accounted for as a pool in accordance with ASC 310-30-15-6.

ASC 310-30-40-1 specifies that when loans are accounted for in the aggregate as a single pooled asset, the integrity of the pool must be maintained. Loans may be removed from the pool of loans “only if the investor sells, forecloses, or otherwise receives assets in satisfaction of the loan, or the loan is written off, and it shall be removed at its carrying amount.” However, ASC 310-30 does not specify how an entity should determine the carrying value of the loan removed from the pool. The notice for recipients of the consensus-for-exposure will solicit views as to whether the EITF should provide guidance about how an entity should determine the carrying amount of loans that are removed from the pool of loans.

The notice for recipients of the consensus-for-exposure will also solicit comments about whether recipients would prefer, at adoption of this proposed guidance, an option to allow loans accounted for as a single pooled asset to be disassembled and accounted for as individual assets.

The EITF discussed whether disclosure requirements in addition to those required for impaired loans should be required to provide users with more transparency about modifications for loans accounted for under ASC 310-30. However, members of the FASB present at the meeting noted that the Board’s loan loss disclosure project may better address the need for disclosures related to the volume and extent of an entity’s loan modification activities, including for loans accounted as a single pooled asset. The EITF agreed and decided not to propose any additional disclosure requirements in this Issue.

Implications

We believe that the tentative conclusion is consistent with the predominant existing practice, although some diversity in practice exists. We understand that most entities do not apply TDR accounting to acquired loans with deteriorated credit quality that are accounted for as a pool in accordance with ASC 310-30-15-6.

Effective Date and Transition

If affirmed, the consensus-for-exposure will be effective for the first interim period beginning after the issuance of the final consensus (i.e., when the amendments are made to the Accounting Standards Codification) through prospective application. Early adoption will be permitted if an entity has not issued its financial statements for that period.

⁹ ASC 310-30, *Receivables - Loans and Debt Securities Acquired with Deteriorated Credit Quality* (formerly, AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*)

¹⁰ ASC 310-40, *Receivables - Troubled Debt Restructurings by Creditors* (formerly, FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*)

¹¹ ASC 310-10, *Receivables - Overall* (formerly, FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*)

Issue 09-J – Impact of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in which the Underlying Equity Security Primarily Trades

Issue

An entity may grant employee stock options with an exercise price fixed in a currency that is neither the entity's functional currency nor the payroll currency of the employee. For example, Company A's stock trades only in Country X, so Company A chooses to grant its employees stock options denominated in the currency of Country X. Company A's functional currency and payroll currency is from Country Z.

The guidance in ASC 718¹² does not specify which currency denomination is the base case that would be consistent with equity classification. Because these awards are subject to changes in foreign currency exchange rates, they could be considered awards subject to a condition that is not a service, performance or market condition and thus classified as liabilities under ASC 718.

The EITF reached a consensus-for-exposure on Issue 09-J.

The EITF reached a consensus that employee stock options that have exercise prices denominated in the currency of any market in which a substantial portion of the trading activity for the underlying equity security occurs should be classified as equity. ASC 718-10-25-13 states that "an award may be indexed to a factor in addition to the entity's share price. If that additional factor is not a market, performance, or service condition, the award shall be classified as a liability for purposes of this Topic." While the reasons for certain EITF members' support for this view may have differed, some EITF members concluded that the strike price of such share-based payments represents a market condition and therefore would be considered an equity award, assuming all other criteria for equity classification are met.

As suggested by the title of this Issue, the EITF considered whether to limit its conclusion to the market in which the underlying equity security *primarily* trades. The Proposed ASU will solicit comments as to whether basing the conclusion on a market that represents a substantial portion of the entity's share trading volume, consistent with the consensus-for-exposure, is a more appropriate threshold.

The consensus-for-exposure will not contain any disclosure requirements incremental to those required by ASC 718. However, the ASU Summary will include a reminder that ASC 718 requires an entity to disclose the nature and terms of share-based payment arrangements that existed during the period. Presumably, if an entity has a material amount of share-based payment awards denominated in the currency of the market in which the underlying equity security trades that differs from the entity's functional currency, this likely would be a significant term requiring appropriate disclosure.

Implications

We believe that entities who previously concluded that denominating an equity award in a currency in which the underlying equity award trades would preclude equity treatment, generally chose not to denominate the exercise price of awards in that way. Further, we believe that the predominant view in practice (as described in section S5.2.4.1 of our Financial Reporting Developments publication, *Share-Based Payment*) is consistent with the consensus-for-exposure. Therefore, the tentative conclusions reached generally will validate existing practice for outstanding awards. Some entities may wish to reconsider their policy for denominating equity awards to the extent that they believe it would be preferable to denominate awards in the currency in which their shares trade.

Effective date and transition

If affirmed, the consensus-for-exposure will be effective for fiscal years, and interim periods within those fiscal years, beginning on or after 15 December 2010. The consensus-for-exposure will be adopted through a cumulative effect adjustment to the opening balance of retained earnings as of the beginning of the fiscal year in which the Issue is initially applied. Early adoption will be permitted.

¹² ASC 718, *Compensation – Stock Compensation* (formerly, FASB Statement No. 123(R), *Share-Based Payment*)

Issues discussed without conclusion

Issue 09-2 – Research and Development Assets Acquired and Contingent Consideration Issued in an Asset Acquisition

Issue

Research and development assets acquired in a business combination after the effective date of Statement 141(R) (codified as ASC 805)¹³ are initially recognized and measured at fair value. Pursuant to ASC 730-10,¹⁴ research and development assets acquired in an asset acquisition are only capitalized if the assets have a future alternative use; otherwise, the assets are expensed at the acquisition date. Tangible and intangible assets that meet the future alternative use criterion are initially measured at allocated cost.

Prior to the effective date of Statement 141(R), the accounting for acquired in-process research and development was the same whether acquired in a business combination or an asset acquisition. The change resulting from Statement 141(R) causes similar transactions to be accounted for differently depending on the method of acquisition.

The EITF was unable to reach a consensus and does not expect to further discuss this Issue.

Certain EITF members believe the guidance in the proposed consensus-for-exposure would not achieve its objective of aligning the accounting for research and development assets acquired in an asset acquisition with those acquired in a business combination. Certain EITF members also believe that the proposed amendments in the Proposed Accounting Standards Update (ASU) will have broader implications than originally anticipated or intended. For example, the Proposed ASU as written could potentially require capitalization of an asset related to some license and royalty arrangements in which the royalty payments are currently expensed as the associated revenue is recognized (if the royalty arrangement is considered contingent consideration). Additionally, certain EITF members expressed concerns that the accounting for research and development activities (or possibly all intangible assets) should be addressed in a comprehensive project by the FASB. After considerable debate, the EITF was unable to reach a consensus on the Issue.

Because the EITF was unable to reach a consensus, the EITF Chairman indicated that he will recommend that the FASB chairman consider whether to address this issue as part of a broader project. The EITF is not expected to discuss the Issue further.

Implications

The EITF's failure to reach a consensus on Issue 09-2 means that there will be no change in the accounting for research and development assets (including any contingent consideration) acquired in an asset acquisition.

¹³ ASC 805, *Business Combinations* (formerly, FASB Statement No. 141(R), *Business Combinations*)

¹⁴ ASC 730-10, *Research and Development—Overall* (formerly, FASB Statement No. 2, *Accounting for Research and Development Costs*)

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