Emerging Issues Task Force
Agenda Committee Report
October 11, 2006

Emerging Issues Task Force Agenda Committee
Decisions on Proposed Issues

1. Accounting for the Tax Benefit of Dividends on Restricted Stock and Option Awards

Background

Employees may receive, as part of a compensation arrangement, dividends on their restricted stock or option awards during the vesting period or, for option awards, until the option is exercised (a provision known as "dividend protection"). FASB Statement No. 123 (revised 2004), *Share-Based Payment*, provides guidance on the accounting for these dividends and states that dividends paid on nonvested shares and dividend-protected options that are expected to vest shall be factored into the fair value of the award. The fair value of dividend paying stock already incorporates the expected payment of dividends and, therefore, the company would make no adjustment to the fair value of restricted shares for the expected payment of dividends during the vesting period.[1] However, the fair value of an option that pays dividends should be adjusted to appropriately reflect the dividend protection.[2] Statement 123(R) states that the payment of dividends on restricted stock or option awards should be accounted for in retained earnings if the shares are expected to vest. They should not be accounted for as additional compensation since this would result in the double-counting of compensation expense.

If an employee makes an Internal Revenue Code Section 83(b) (IRS Sec. 83(b)) election for restricted stock, the employee will receive capital gain treatment during the vesting period (in contrast, if the election is not made, then the IRS treats the appreciation in the stock during the vesting period as ordinary income). If this election is made, the dividends paid on the stock are treated like ordinary dividends paid to shareholders. That is, the company does not receive a tax benefit for the payment of dividends. If an employee does not make this election, then the dividends paid to the employee are not treated as dividends paid to a shareholder because the IRS

[1] Statement 123(R) goes on to state that if an employee does not receive dividends declared on a class of shares granted to them until the shares vest, the "grant-date fair value of the award is measured by reducing the share price at that date by the present value of the dividends expected to be paid on the shares during the requisite service period, discounted at the appropriate risk-free interest rate" (paragraph B93).

[2] The fair value of an option is discounted for expected dividends during the period the option is unexercised. Therefore, if dividends are paid on the option, the fair value of the option would be adjusted to eliminate the discount of the expected dividends.

does not recognize the employee as having received the restricted shares until the restriction lapses (that is, until the shares vest). Therefore, the IRS treats the payment of these dividends as compensation and the entity is able to receive a deduction on the dividends paid. Likewise, dividends paid as part of a dividend protection plan for option awards are treated as compensation for U.S. tax purposes.

Consequently, companies that pay dividends on restricted stock or option awards (when an IRS Sect. 83(b) election is not made) that are reflected within retained earnings during the vesting period will receive a tax deduction on those dividends. Questions have arisen on the accounting treatment for the tax benefit the company receives on those dividends.

Accounting Issue and Alternatives

Issue: How a company should recognize the tax benefit received on dividends paid to employees for restricted stock and option awards.

View A: The tax benefit received on dividends that are paid to employees for restricted stock and option awards (that have not vested or are dividend protected) should be recognized as a component of income tax expense.

Proponents of View A reference paragraph 145 in FASB Statement No. 109, Accounting for Income Taxes, which states, in part:

> The Board believes that <u>a tax deduction received for the payment of dividends</u> (exclusive of dividends paid on unallocated shares held by an ESOP) represents, in substance, <u>an exemption from taxation of an equivalent amount of earnings</u>. For that reason, the Board concluded that the tax benefit should be recognized as a reduction in tax expense and should not be allocated directly to shareholders' equity. [Emphasis added.]

Proponents of View A believe that these dividends are analogous to the accounting treatment for dividends on allocated shares in an ESOP. In both cases, an award is "assigned" to employees. Proponents of View A point out that allocated shares in ESOPs are assigned to an employee;

however, they have not necessarily vested (and could wind up allocated to other ESOP participants). Likewise, in the case of restricted shares or options under other types of compensatory arrangements, the awards have been given, and therefore assigned, to the employee, but have not necessarily vested. Proponents believe that there should be no difference in the accounting for the tax-deductible dividends between an allocated share in an ESOP or a restricted share or option that has been granted to an employee.

View B: The tax benefit received on dividends that are paid to employees for restricted stock and option awards (that have not vested or are dividend protected) should be accounted for as a reduction in the deferred tax asset that is associated with the award.

Proponents of View B believe that because the present value of expected future dividends is included in the fair value of the award at the grant date, the payment of that dividend and the resulting tax benefit represents a partial realization of the deferred tax asset that was established when the compensation cost associated with that award was recognized. Proponents of View B look to the model within Statement 123(R) for support. Statement 123(R) requires the value of the dividends in either restricted stock or option awards that are paid during an employees' vesting period or during the life of an option, to be included in the fair value of the award. If the award did not include the payment of dividends, the fair value of the award would be adjusted to exclude them. Proponents of View B believe that their view is consistent with the guidance in Statement 123(R) because the value of the dividends paid is a component of the compensation cost being recognized during the vesting period and, therefore, they also believe that the related tax deduction from the dividends should be attributable to that compensation cost. Consequently, the tax deduction from the dividends is considered a partial reversal of the temporary difference associated with the compensation cost recognized for the award.

View C: The tax benefit received on dividends that are paid to employees for restricted stock and option awards (that have not vested or are dividend protected) should be accounted for as a credit to additional paid-in-capital (APIC).

Proponents of View C reference paragraph 35 of Statement 109 which states, in part:

> Income tax expense or benefit for the year shall be allocated among continuing operations…or credited to shareholder's equity. The amount allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of…tax-deductible dividends paid to shareholders (except as set forth in paragraph 36 for dividends paid on unallocated shares held by an employee stock ownership plan [ESOP] <u>or any other stock compensation arrangement</u>). [Emphasis added.]

Proponents of View C believe that the tax-deductible dividends on restricted stock or option awards (that have not vested or are dividend protected) reflect another stock compensation arrangement because the employer elected to provide those dividends to the employee during the vesting period (that is, the employer could have decided not do so). View C proponents believe that recording the tax benefit from the dividends in APIC is consistent with the accounting required in Statement 109 for the payment of dividends on ESOP shares that are not yet earned. View C proponents refer paragraph 144 of Statement 109, which states, in part:

> The Board also believes that the requirements of this Statement for tax-deductible dividends paid on shares held by an ESOP <u>but not yet earned by employees</u> are consistent with the requirements of Statement 96 and Opinion 25. An ESOP and a stock option plan are analogous. Both are compensatory arrangements and both sometimes result in tax deductions for amounts that are not presently recognized as compensation expense in the financial statements under existing generally accepted accounting principles. <u>The tax benefits of both are reported as a credit to shareholder's equity</u>. [Emphasis added.]

View C proponents believe tax-deductible dividends that are paid as part of a compensatory arrangement should be accounted for similarly to differences in tax consequences for stock compensation programs. That is, if a tax deduction is received and there has been no related compensation expense recognized, then Statement 123(R) and paragraph 36(e) of Statement 109 would require that benefit to be recognized within APIC.

<u>Agenda Committee Decisions:</u> ***The Agenda Committee agreed to add this issue to the EITF agenda.***

2. Accounting for the Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements

Summary

At the September 7, 2006 EITF meeting, the Task Force reached a consensus on EITF Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements," that for an endorsement split-dollar life insurance arrangement, an employer should recognize a liability for future benefits in accordance with FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, (if, in substance, a postretirement benefit plan exists) or APB Opinion No. 12, *Omnibus Opinion—1967*, (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. Previously, at the June 15, 2006 EITF meeting, a Task Force member requested that the staff research, for consideration by the EITF Agenda Committee, whether the tentative conclusion reached on Issue 06-4 should also apply to collateral assignment types of arrangements. At its August 3, 2006 meeting, the Agenda Committee discussed this potential new issue but deferred making a decision pending the outcome of Issue 06-4.

Background

Companies purchase life insurance for various reasons that may include protecting against the loss of "key" employees, funding deferred compensation and postretirement benefit obligations, and providing an investment return. One form of this insurance is split-dollar life insurance. The structure of split-dollar life insurance arrangements can be complex and varied.

The two most common types of arrangements are endorsement split-dollar life insurance policies and collateral assignment split-dollar life insurance policies. Generally, the difference between these arrangements is the ownership and control of the life insurance policy. In an endorsement split-dollar life insurance policy, the company owns and controls the policy, whereas in a collateral assignment split-dollar life insurance policy, the employee (or the employee's estate or trust) owns and controls the policy. The terms of a typical collateral assignment split-dollar life insurance arrangement are as follows (refer to Issue 06-4 for the terms of a typical endorsement split-dollar life insurance arrangement):

> An employee (or an employee's estate or trust) purchases a life insurance policy to insure the employee's life and/or the life of the employee's spouse. In other circumstances, an employer purchases a life insurance policy to insure the life of an employee and transfers ownership of the policy to the employee. The employee (or the employee's estate or trust) owns the insurance policy and controls all rights of ownership. The employer usually pays all or a substantial part of the premium. The employee (or the employee's estate or trust) irrevocably assigns a portion of the death benefits to the employer as collateral for the employer's interest in the policy. Amounts due to the employer vary but, typically, the employer is entitled to receive a portion of the death benefits equal to the premiums paid by the employer or premiums paid plus an additional fixed or variable return on those premiums. Upon retirement, the employee may have an option to buy the employer's interest in the insurance policy.

The FASB staff has been informed that the use of these arrangements has greatly diminished since the introduction of the Sarbanes Oxley Act of 2002 (for both public and private entities), because many entities believed that these arrangements would be considered employee loans, which are expressly prohibited under the Act. Entities that continue to maintain these policies typically account for them as employee loans and apply the provisions of APB Opinion No. 21, *Interest on Receivables and Payables*. Accordingly, an employer would record a receivable from the employee at a discounted amount for the premiums paid.

Accounting Issue and Alternatives

Issue: Whether an entity should record a liability for the postretirement benefit associated with a collateral assignment split-dollar life insurance arrangement in accordance with either Statement 106 or Opinion 12.

View A: An employer should not recognize a liability for the postretirement benefit related to a collateral assignment split-dollar life insurance arrangement.

View A proponents believe that consistent with the consensus reached in Issue 06-4, "an employer should recognize a liability for future benefits in accordance with Statement 106 (if, in substance, a postretirement benefit plan exists) or Opinion 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee." However, they argue that under a collateral assignment split-dollar life insurance arrangement, the substantive agreement with the employee is that the employer will pay the premiums under the policy. Under these arrangements, the employer is legally entitled to recover the premiums paid through either the death benefit or the cash surrender value upon cancellation of the policy by the employee. In other cases, the employee (or the employee's estate or trust) will repay the employer for the premiums and accrued interest when the employee retires. Therefore, View A proponents believe that the only postretirement benefit that would need to be accrued during the employee's active service relates to any premium payments that would be paid during the employee's retirement. However, since a majority of these policies are either single premiums or front-loaded premiums, an employer typically will not be required to pay a premium that extends into the employee's retirement.

Additionally, View A proponents believe that a collateral assignment policy is substantively different from an endorsement policy and, therefore, the accounting should not be the same. For example, as noted by the Task Force in Issue 06-4, under an endorsement split-dollar life insurance arrangement, the employer owns and controls the policy and also remains subject to the positive and negative experience of the insurance company. Therefore, a settlement of the benefit promised to the employee has not occurred. Under a collateral assignment arrangement, View A proponents believe that even if a death benefit reflects the substantive agreement with the employee (and View A proponents believe this to be rare), an obligation would not have to be recorded since the collateral assignment policy would effectively settle the postretirement benefit obligation in accordance with Statement 106 or Opinion 12. That is because the purchase of the policy is irrevocable (that is, the employer cannot cancel the policy) and the employee, not the employer, is subject to the positive and negative experience of the insurance company.

View B: An employer should recognize a liability for the postretirement benefit related to a collateral assignment split-dollar life insurance arrangement in accordance with either Statement 106 or Opinion 12.

View B proponents believe that there is no economic difference between an endorsement split-dollar life insurance arrangement and a collateral assignment split-dollar life insurance arrangement and, therefore, the accounting should be the same. For example, they note that in either case, both the employer and the employee will receive the same benefit, which may be in the form of a death benefit or an agreement to maintain the premiums of the policy in the postretirement period.

Additionally, View B proponents believe that similar to an endorsement split-dollar life insurance arrangement, the employer remains subject to the positive and negative experience of the insurance company. That is, the employer is obligated to pay the premium under the policy and if the employee were to default under its "loan" with the employer, the cash surrender value may not be sufficient to cover the premiums paid. Accordingly, proponents of View B believe that similar to the consensus reached by the Task Force in Issue 06-4, the postretirement obligation would not be settled in accordance with either Statement 106 or Opinion 12.

Agenda Committee Decisions: ***The Agenda Committee agreed to add this issue to the EITF agenda.***

3. Determining the Attribution of Incentive Compensation to Interim Financial Statements

Background

Diversity exists in the method companies utilize to attribute expenses associated with both short-term incentive compensation plans ("STIP") and long-term incentive compensation plans ("LTIP") to interim periods within a year. This issue addresses the attribution of the incentive compensation amounts to interim periods and does not address the interim measurement of the amount that is considered probable and reasonably estimable of payment.

The issue is best described by the following illustration:

> Company A has adopted an STIP and an LTIP covering key employees. Incentive payments under the STIP and LTIP are subject to the Company meeting or exceeding specified financial measures (for example, targets for net income, earnings per share (EPS), return on invested capital (ROIC), and so forth). The Compensation Committee of the Board of Directors establishes the performance measures and targets for each respective award or period. The general structure is as follows:

- For performance below the threshold, no incentive compensation is paid.
- Once the financial performance exceeds the threshold but is below a maximum incentive target, the payout increases in some ratable fashion.
- Attainment targets above the specified maximum do not result in further increases in incentive compensation.

Since both the STIP and the LTIP are similar in structure and design, this discussion and analysis has generally been limited to the STIP.

The STIP measurement period spans one year and requires that the key employees render service for the entire annual period and be employed at the end of the yearly period. Pro rata distributions are made for new employees and retirees, as defined, during the annual period. It is also assumed that the award is paid in cash, and is not subject to FASB Statement No. 123, *Share-Based Payment* (revised 2004).

Accounting Issue and Alternatives

Issue: How an entity should attribute STIP or LTIP to interim financial statements when the STIP or LTIP is determined based on achievement of an annual financial performance target.

View A: An entity should attribute STIP or LTIP to interim financial statements based on the proportionate achievement of annual financial performance target.

Proponents of View A reference the guidance in APB Opinion No. 28, *Interim Financial Reporting*. Proponents of View A believe that Opinion 28 expresses a broad objective but does not mandate any particular attribution methodology. For example, paragraph 17 of Opinion 28 requires that "… interim periods bear a <u>reasonable portion</u> of the anticipated annual amount" (emphasis added). Proponents of View A believe that this could be interpreted to allow any methodology that produces a reasonable allocation. Proponents of View A also believe that View A is consistent with the reference in paragraphs 12(b) and 15(a) of Opinion 28 that the cost "… be allocated among interim periods based on an estimate of time expired, <u>benefit received or activity associated with the periods</u>" (emphasis added).

Proponents of View A also believe that the recognition, matching, and allocation principles set forth in FASB Statement of Concepts No. 6, *Elements of Financial Statements*, paragraphs 145 and 146, provide a basis for allocation of the incentive compensation related to certain events and transactions to be recorded in the period in which the benefit is received or the activity occurs. Paragraphs 145 and 146 of Concepts Statement 6 provide the following guidance:

> 145. Accrual accounting uses accrual, deferral, and allocation procedures whose goal is to relate revenues, expenses, gains, and losses to periods to reflect an entity's performance during a period instead of merely listing its cash receipts and outlays. Thus, recognition of revenues, expenses, gains, and losses and the related increments or decrements in assets and liabilities—including matching of costs and revenues, allocation, and amortization—is the essence of using accrual accounting to measure performance of entities. <u>The goal of accrual accounting is to account in the periods in which they occur for the effects on an entity of</u>

> transactions and other events and circumstances, to the extent that those financial effects are recognizable and measurable. [Emphasis added.]
>
> 146. Matching of costs and revenues is simultaneous or combined recognition of the revenues and expenses that result directly and jointly from the same transactions or other events. In most entities, some transactions or events result simultaneously in both revenue and one or more expenses. The revenue and expense(s) are directly related to each other and require recognition at the same time. In present practice, for example, a sale of product or merchandise involves both revenue (sales revenue) for receipt of cash or a receivable and expense (cost of goods sold) for sacrifice of the product or merchandise sold to customers. Other examples of expenses that may result from the same transaction and be directly related to sales revenue are transportation to customers, sales commissions, and perhaps certain other selling costs. [Emphasis added.]

To calculate the interim accrual under View A, each quarter an estimate of the annual payout under the STIP (or LTIP) would be calculated based on a current forecast of the end of the year metric on which the performance award is based. The percentage of the annual performance that has been achieved to date is applied to the annual STIP (or LTIP) incentive to calculate the interim incentive to be recorded. If, on an annual basis, incentive compensation is expected to be paid, this attribution method could result in zero incentive compensation expense in a period (because the performance metric was unchanged from the prior period) or negative compensation expense (because the performance against the metric decreased). An example of the application of View A based on the illustration described in the background section is as follows:

Assumptions:
Annual Bonus Estimate: $30 million
Annual Net Income Forecast: $68 million

	Net Income (Loss)	**% of Annual Forecast**	**Bonus Expense**	**Ending Accrual**
Q1	$20,000,000	29.4%	$ 8,823,529	$ 8,823,529
Q2	(2,000,000)	-2.9%	(882,353)	7,941,176
Q3	35,000,000	51.5%	15,441,176	23,382,353
Q4	15,000,000	22.1%	6,617,647	30,000,000
Total	$68,000,000	100.0%	$30,000,000	

View B: An entity should attribute STIP or LTIP to interim financial statements on a straight line basis, based on the relative proportion of service period rendered to date.

Proponents of View B believe that in each interim period an entity should make its best estimate of the STIP or LTIP bonus that is probable of payment at the end of the year, but that the estimated compensation expense should be attributed to interim financial statements as the services are performed by the employee; that is, on a straight-line basis over the service period. At the end of each interim period, the amount of the award that is considered probable of payment should be reassessed reflecting the latest available information.

View B proponents reference the same literature as in View A. However, proponents of View B believe that the exchange being made between a company and an employee for offering the STIP or LTIP is for the employee's services. Since employee services are rendered ratably over the course of the award period, the only method that results in each period bearing a "reasonable portion" of the expected annual expense is the straight-line method.

Further, View B proponents analogize to Statement 123(R) for the treatment of a service and performance condition related to a stock award. Essentially, when a stock award contains both a service condition and a performance condition, an estimate is made of the probable award. The probable award is then expensed over the requisite service period on a straight-line basis. The requisite service period is the period over which the employee is required to provide service, which would be similar to the one-year service period required by the STIP.

Agenda Committee Decisions: ***The Agenda Committee decided not to add this issue to the EITF agenda.***

4. The Application of the Two Class Method to Master Limited Partnerships for FASB Statement No. 128, *Earnings per Share.*

Background

Publicly traded master limited partnerships often issue multiple classes of securities, each of which may participate in partnership distributions according to formulae specified in the partnership agreement. An investor's participation in the partnership's distributions often does not mirror the partnership's allocation of the entity's income or losses to the investor's capital accounts. In addition, distributions from the partnership often encompass returns on capital and returns of capital, as well as reallocations of capital between the different classes of investors.

Statement 128 and EITF No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128," provide guidance that the multiple classes of securities issued by such partnerships meet the definition of participating securities, which requires the application of the two-class method. However, upon applying the two-class method to such securities, there is a question as to how an entity should allocate earnings to the various classes of security holders. Specifically, master limited partnerships often have multiple classes of securities outstanding. Some classes are designed to maintain a zero capital balance (that is "earnings" are allocated to the capital accounts associated with that class in an amount that offsets any debit balance created by the distribution of cash). In periods in which earnings are not sufficient to cover distributions to the various partnership interests, the capital accounts of the remaining classes of partnership interests will absorb the "debit" created by the allocation of earnings to the preferential class. It is also not uncommon for such partnerships to encounter substantial timing differences between the distribution of cash and the recognition of income. This may be due to large non-cash charges occurring early in the entity's life (that is, depreciation, depletion, and amortization). Thus, early in their lives, these partnerships often will distribute cash in excess of their reported earnings. Alternatively, the partnership may operate in a seasonal industry, such that earnings and/or cash are generated primarily in one quarter, but cash distributions are made over the course of a year.

Statement 128 presumes that distributions from an entity represent a distribution of earnings. Thus, Statement 128 requires that distributions be allocated to each class of security based on its participation in such distributions, with net income being reduced by the amount of such distributions. This adjusted net income figure is then allocated to each class of security based on the manner in which each class of security would participate in earnings if the adjusted net income figure were to be distributed by the entity (that is, the process by which the undistributed earnings are allocated).

The interaction of the following items has resulted in varying interpretations of the manner in which earnings (or the lack thereof) should be allocated to the various classes of securities that comprise the capital structure of master limited partnerships:

- Timing differences between the recognition of earnings and the distribution of cash
- The existence of different "waterfalls" for allocating cash distributions, earnings, and losses of the partnership
- Shifting allocations of distributions to the various classes of security holders as the absolute level of distributions increases
- The existence of distributions that represent returns of capital, returns on capital, and reallocations of capital between interest holders
- The Statement 128 presumption that distributions of cash represent distributions of earnings.

In addition, seasonal businesses often find that the two-class method's requirement to allocate undistributed earnings to the various classes of securities as if such earnings had been distributed in the current period results in a full year earnings per share figure that equals neither the sum of the reported quarterly earnings per share figures nor the actual distributions for each class of security for the whole year. This is due to the fact that the assumed distribution of earnings in profitable quarters, coupled with the sliding scale participation in actual distributions that is often mandated by the partnership agreement, results in the allocation of earnings to a class of security during the profitable quarters. On a full year basis, losses that occur in subsequent quarters reduce total earnings to a level below the level at which the class would actually participate.

For MLP's, the distributions of available cash to each of the interest holders typically do not mirror the allocation of income or loss to each of their respective capital accounts. In fact, differences between the manner in which available cash is distributed and the manner in which earnings are allocated to the separate capital accounts of the MLP often include what amounts to a "return of capital" or a reallocation of capital between the various classes of security holders.

Accounting Issues and Alternatives

Issue 1: How earnings should be allocated when applying the two-class method.

View A: Earnings should be allocated based on actual cash distribution rights.

Proponents of View A reference paragraph 61(b) of Statement 128 which requires that the allocation of earnings for purposes of calculation earnings per share should be made “as if” all earnings were distributed for the period. To the extent that the partnership agreement specifies the allocation of undistributed earnings in a manner that differs from the allocation of distributions, the amounts allocated to capital accounts would not equal the allocation of earnings to each class of security for purposes of calculating earnings per unit.

View B: Earnings should be allocated based on ownership rights (which equates to earnings).

Unlike typical corporations, MLP structures typically maintain separate capital accounts (including retained earnings) for each class of partnership interest. As a result, to be consistent with the fact that partnerships do maintain separate capital accounts for each class of security holder, allocation of earnings for purposes of computing earnings per unit should follow the same allocation formula specified in the partnership agreement.

Potential Sub-Issues

Issue 2: If the response to Issue 1 is View A, for periods in which earnings of the MLP exceed distributions of available cash, how the excess earnings should be allocated for presentation of earnings per unit.

Issue 3: If the response to Issue 1 is View A, for periods in which earnings of the MLP are less than distributions of available cash, how the excess distributions should be allocated for presentation of earnings per unit.

Issue 4: For periods of net loss, how the net loss should be allocated for purposes of computing earnings per unit.

Agenda Committee Decisions: ***The Agenda Committee agreed to defer making a decision on this potential new issue pending a decision on the Committee's recommendation that the FASB and the IASB consider including this issue either as part of the short-term international convergence project on earnings per share or alternatively recommending that the FASB address this matter through the issuance of an FASB Staff Position***.

5. The Effect of a Sale of Receivables with Recourse under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, on the Determination of Profit Recognition for the Sale of Real Estate Pursuant to FASB Statement No. 66, *Accounting for Sales of Real Estate*

Background

The increasingly popular non-traditional seller financing arrangements (for example, minimal down payment mortgages, non-amortizing loans, negative amortization loans, and combination seller extended first and second mortgages) differ from what have historically been viewed as normal amortizing loans (that is, a 30-year fixed rate mortgage). These non-traditional seller financed loans, coupled with the accounting for subsequent transfers of the seller financed loans to third parties, have raised questions regarding the interaction of Statement 66 with FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, since Statement 66 is based on a risk and rewards standard, and derecognition of the seller's receivable under Statement 140 is based on a determination of whether control has been surrendered.

Many homebuilders own captive mortgage companies used to fund mortgage loans originated in connection with the homebuilder's home sales. Usually, the captive mortgage companies do not service or retain these loans, but sell 100 percent of them (and the associated servicing rights) to unrelated third-party institutional investors or government-sponsored enterprises within 60 days following the loan origination. These sale agreements typically include representations and warranties (that is, absence of known fraud in origination, conformity of loan documentation, and first lien perfection) and, in many cases, early payment default (EPD) provisions (generally one to six months). For example, under a one-month EPD provision, the loan purchaser can require the homebuilder's mortgage company to repurchase the loan if the homebuyer does not make the first mortgage payment subsequent to the purchase of the loan by the loan purchaser. In some cases, the homebuilder's mortgage subsidiary will securitize the mortgage loan and retain subordinate interests in the securitization.

The following is an example of a typical transaction:

> Homebuilder sells a completed single family home to Customer who is purchasing the home as a primary residence. Customer finances the purchase through Homebuilder's residential mortgage subsidiary. The terms of the mortgage are 0 percent down with a 30-year amortization. In conjunction with the closing of the sale, Homebuilder sells the receivable to a third party that is not consolidated by Homebuilder. Assume Homebuilder receives cash in return for the receivables and has no continuing involvement with the transferred receivables except that if the borrower defaults within the next 90 days, the transferee may put the loan back to the Homebuilder (either by requiring Homebuilder to repurchase the loan or substitute another loan). Homebuilder has concluded it is remote that the borrower will default and can demonstrate historical data indicating such defaults do not occur at a significant level in the guarantee period.

Statement 66, paragraph 5, states, in part:

> Profit on real estate sales transactions shall not be recognized by the full accrual method until all of the following criteria are met:
>
> a. A sale is consummated (paragraph 6).
> b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property (paragraphs 8-16).
> c. The seller's receivable is not subject to future subordination (paragraph 17).
> d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property (paragraph 18). [Footnote reference omitted.]

Non-traditional forms of seller financing often result in difficulty for the seller to satisfy paragraph 5(b) of Statement 66, the buyer's initial and continuing investment tests. The purpose of the initial and continuing investment tests is to assess the buyer's commitment to pay for the property rather than to simply measure the cash received by the seller which was clarified in EITF Issue No. 88-24, "Effects of Various Forms of Financing under FASB Statement No. 66." Issue 88-24, states, in part:

> The initial and continuing investment requirements for the full accrual method of profit recognition of FAS 66 are applicable unless the seller receives as the full sales value of the property (a) cash, without any seller contingent liability on any debt on the property incurred or assumed by the buyer, (b) the buyers assumption of the seller's existing nonrecourse debt on the property, (c) the buyer's assumption of all recourse debt on the property with the complete release of the seller from those obligations, or (d) any combination of such cash and debt assumption. When the seller has unconditionally received all amounts it is entitled to from the sale and is not at risk related to the financing, the buyer's commitment to pay for the property is not a factor in the seller's recognition of profit.

Statement 66, paragraph 9, states:

> The buyer's initial investment shall include only: (a) cash paid as a down payment, (b) the buyer's notes supported by irrevocable letters of credit from an independent established lending institution, (c) payments by the buyer to third parties to reduce existing indebtedness on the property, and (d) other amounts paid by the buyer that are part of the sales value. Other consideration received by the seller, including other notes of the buyer, shall be included as part of the buyer's initial investment only when that consideration is sold or otherwise converted to cash without recourse to the seller.

One of the key reasons for Issue 88-24 was to conclude that simply selling a receivable did not help in meeting the initial or continuing investment tests; however, the sale of a receivable should be factored into determining whether or not the tests are applicable.

Under Statement 66, if the initial investment is not met, the installment, deposit, or cost recovery method shall be used. If the initial investment test is satisfied, but the continuing investment criteria are not satisfied, then the reduced-profit method may be used provided that at the time of sale the scheduled annual payments will cover both:

- Interest and principal amortization on the maximum first mortgage loan that could be obtained on the property, and
- Interest (at an appropriate rate determined in accordance with APB Opinion 21, *Interest on Receivables and Payables*) on the portion of the debt exceeding the maximum first mortgage loan.

If the preceding criteria for using the reduced-profit method are not met, then the installment method or the cost recovery method should be used.

Statement 140 requires that a transferor recognize any newly-created assets obtained and liabilities incurred in a transaction as proceeds of the sale. These items usually would include put or call options held or written, guarantee or recourse obligations, forward commitments to deliver additional receivables (for example, in connection with reinvestment provisions), swaps (for example, provisions that convert interest rates earned by the transferee from the fixed rate paid by the debtor to a variable rate), and servicing liabilities, if applicable. These items would be initially measured at fair value for purposes of applying Statement 140. In addition, Statement 140 requires that retained interests, which may provide credit enhancement to the purchaser, be recorded by the seller.

While Statement 140 permits sales of receivables in many instances when recourse obligations are retained, Issue 88-24 requires the application of the initial and continuing investment tests unless the seller receives the full sales value of the property without any seller-contingent liability on any debt on the property incurred or assumed by the buyer.

Accounting Issue and Alternatives

Issue: When an entity sells real estate and provides loan financing to the buyer such that the initial and continuing investment tests are not met, whether the subsequent sale of the loan receivable under Statement 140 qualifies in the evaluation of whether the initial and continuing investment tests have been met under Issue 88-24 and Statement 66 if certain recourse obligations are retained.

View A: The sale of a receivable with recourse does not result in profit recognition under Statement 66.

Proponents of View A recognize the inconsistency between the models in Statement 66 and Statement 140 but believe profit recognition on the sale of real estate is determined solely in accordance with Statement 66. In that regard they believe that Statement 66 and Issue 88-24 are explicit that a sale of receivables must be without any recourse in determining the applicability of the initial and continuing investment tests. Supporters of View A also point out that in the case of an EPD, all credit risk remains with the Homebuilder despite the sale of the receivable pursuant to Statement 140. As a result, they believe the transaction is first one of revenue recognition on the sale of real estate where the provisions for gain recognition are determined by Statement 66 versus Statement 140.

Proponents of View A believe that Statement 66 is a transaction-by-transaction recognition standard and that, despite anecdotal evidence as to the reason EPD's have arisen and the likelihood of loss over a large population being minor, the individual receivable has not been sold without recourse. Supporters of View A also note that if the likelihood of loss or default were a relevant factor in determining profit recognition under Statement 66, the receivable would not need to be transferred to factor into the analysis.

View B: A sale of the receivable that qualifies as a sale under Statement 140 should be viewed as appropriate for determining whether the initial and continuing investment tests are applicable.

Supporters of View B note that while Statement 66 is the appropriate guidance for gain recognition, Statement 140 is the appropriate guidance under which to determine whether or not a lender continues to hold a receivable. In their view, since the Statement 66 initial and continuing investment tests are for evaluating the collectibility of the seller's receivable, there is no collectibility to assess whether the receivable has been sold.

Supporters of View B believe that the EPD provisions represent effectively another form of industry standard representation and warranty by the homebuilder/captive mortgage company related to fraud. That is, if the Homebuyer does not make their initial payments shortly after loan origination (that is, first 1 to 6 payments), mortgage industry participants presume that the origination of such loan was flawed in some respects, including the possibility of mortgage fraud (for example, inflated appraisal). These EPD provisions became customary in the mortgage banking industry as a useful contractual tool between loan sellers and buyers to avoid significant disputes and the expenditure of inordinate amounts of legal fees in proving that fraud existed in these relatively rare situations. Repurchases of loans due to violations of standard representations and warranties and EPD provisions have been immaterial to loan sale volumes and the losses on repurchases have not been significant. Accordingly, the Homebuilders concluded that, in substance, at loan sale no substantive significant unresolved contingency exists that would preclude revenue recognition for the underlying home sale by the Homebuilder.

Agenda Committee Decisions: ***The Agenda Committee decided not to add this issue to the EITF agenda. The Committee recommended that the FASB pursue the issuance of an FASB Staff Position to provide guidance on this issue.***

FASB EMERGING ISSUES TASK FORCE
Proposed November 16, 2006 Meeting Agenda

Issue Number	Issue	Proposed Time	Staff Assigned
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 Entity or between the Reporting Period of an Investor and That of an Equity Method Investee	8:00-8:30	Cosper/ Beswick
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	8:30-9:00	Akinlade/ Beswick
06-J	Accounting for the Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements	9:00-10:00	Trench/ Cosper
	* * * BREAK * * *	10:00-10:15	
06-H	Application of AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*, to Entities That Engage in Commodity Trading Activities	10:15-11:30	Fanzini/ Jacobs
	Administrative Matters - New Issues - Other Matters	11:30-12:00	Cosper
	* * * LUNCH * * *	12:00-1:00	
06-K	Accounting for the Tax Benefit of Dividends on Restricted Stock and Option Awards	1:00-2:00	Stevens/ Paul

Issue Number	**Issue**	**Proposed Time**	**Staff Assigned**
	* * * BREAK * * *	2:00-2:15	
06-6	Debtor's Accounting for a Modification (or Exchange) of Convertible Debt Instruments	2:15-2:45	Stevens/ Jacobs
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*	2:45-3:30	Roberge/ Stevens

Status of Open Issues and Agenda Committee Items

The following represents the FASB staff's assessment of the status and immediate plans with respect to the open Issues on the Task Force's agenda. The Issues on the proposed agenda for the November 16, 2006 meeting are considered either high priority issues or issues on which meaningful progress can be made within the staff's given complement of resources. The staff's prioritization of issues is based primarily on the FASB staff's understanding of the level of diversity in practice created by each respective Issue, the financial reporting implications of that diversity, the current interaction, if any, of the Issues with active Board projects, and current resource availability among the staff (with respect to both time and relevant technical expertise).

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	EITF Liaison	FASB Staff	Immediate Plans	Due Date - Next Deliverable
06-6	Application of EITF Issue No. 05-7, "Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues"	6/06 and 5/06	6/06 9/06	11/06	Holman	Stevens/ Jacobs	The FASB staff will prepare an Issue Summary Supplement for a future meeting.	November 2006 EITF meeting
06-7	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 Instruments and Hedging Activities*	5/06	9/06	11/06	Johnson	Roberge/ Stevens	The FASB staff will prepare an Issue Summary Supplement for a future meeting.	November 2006 EITF meeting

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	EITF Liaison	FASB Staff	Immediate Plans	Due Date - Next Deliverable
06-8	Application of the Assessment of a Continuing Investment in Paragraph 12 of FASB Statement No. 66, *Accounting for Sales of Real Estate*, to a Sale of a Condominium	8/06	9/06	11/06	Bielstein	Akinlade/ Beswick	The FASB staff will prepare an Issue Summary Supplement for a future meeting.	November 2006 EITF meeting
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 Entity or between the Reporting Period of an Investor and That of an Equity Method Investee	8/06	9/06	11/06	TBD	Cosper/ Beswick	The FASB staff will prepare an Issue Summary Supplement for a future meeting.	November 2006 EITF meeting
06-H	Application of AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*, to Entities That Engage in Commodity Trading Activities	8/06	N/A	11/06	Johnson	Fanzini/ Jacobs	The FASB staff will prepare an Issue Summary for a future meeting.	November 2006 EITF meeting
06-I	Accounting for Joint Development, Manufacturing, and Marketing Arrangements in the Biotechnology and Pharmaceutical Industries	8/06	N/A	3/07	Schroeder	Bolash/ Beswick	The FASB staff will prepare an Issue Summary for a future meeting.	March 2007 EITF meeting

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	EITF Liaison	FASB Staff	Immediate Plans	Due Date - Next Deliverable
06-J	Accounting for the Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements	10/06	N/A	11/06	TBD	Trench/ Cosper	The FASB staff will prepare an Issue Summary for a future meeting.	November 2006 EITF meeting
06-K	Accounting for the Tax Benefit of Dividends on Restricted Stock and Option Awards	10/06	N/A	11/06	Hauser	Stevens/ Paul	The FASB staff will prepare an Issue Summary for a future meeting.	November 2006 EITF meeting

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	**Description**	**Date Added**	**Date(s) Discussed**	**Next Meeting**	**FASB Staff**	**Immediate Plans**	**Due Date - Next Deliverable**
00-18	Accounting Recognition for Certain Transactions involving Equity Instruments Granted to Other Than Employees	5/00	7/00, 7/01, 11/01, 1/02, 3/02	N/A	Sarno	Phase II of the Board's share-based payments project will not be initiated in the foreseeable future and, therefore, the FASB staff will bring this issue to the Agenda Committee at a future meeting to determine whether to begin discussions on this Issue or to request that the Task Force remove this Issue from the agenda.	Future Agenda Committee Meeting

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	**Description**	**Date Added**	**Date(s) Discussed**	**Next Meeting**	**FASB Staff**	**Immediate Plans**	**Due Date - Next Deliverable**
	The remaining issue in Issue 00-18 is Issue 3: For transactions that include a grantee performance commitment, how the grantee should account for the contingent right to receive, upon performing as specified in the arrangement, grantor equity instruments that are the consideration for the grantee's future performance. The Task Force asked the FASB staff to focus on improving the guidance (originally from Issue 96-18) used to determine the date at which a commitment for counterparty performance to earn the equity instruments is reached.						
00-27	Application of EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," to Certain Convertible Instruments	5/00	11/00, 1/01	Not scheduled	Richards	Pending further progress on Phase II of the Board's liabilities and equity project.	N/A
02-D	The Effect of Dual-Indexation both to a Company's Own Stock and to Interest Rates and the Company's Credit Risk in Evaluating the Exception under Paragraph 11(a)(1) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*	3/02	N/A	Not scheduled	Jacobs	Pending further progress on Phase II of the Board's liabilities and equity project.	N/A

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	**Description**	**Date Added**	**Date(s) Discussed**	**Next Meeting**	**FASB Staff**	**Immediate Plans**	**Due Date - Next Deliverable**
03-15	Interpretation of Constraining Conditions of a Transferee in a Collateralized Bond Obligation Structure	11/02	N/A	Not scheduled	Lusniak	The Board's project on QSPE's is not expected to address this Issue and, therefore, the FASB staff will bring this Issue to the Agenda Committee at a future meeting to determine whether to begin discussions on this Issue or to request that the Task Force remove this Issue from the agenda.	Future Agenda Committee Meeting
05-4	The Effect of a Liquidated Damages Clause on a Financial Instrument Subject to EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"	2/05	6/05, 9/05	N/A	Jacobs/ Richards	Pending further progress on a DIG Issue for determining whether a registration rights agreement is a derivative	N/A

Issues Pending Further Consideration by the Agenda Committee							
Issue No.	**Description**	**Date Added**	**Date(s) Discussed**	**Next Meeting**	**FASB Staff**	**Immediate Plans**	**Due Date - Next Deliverable**
N/A	Application of EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," When a Special-Purpose Entity Holds Equity Securities and Whether an Investment That Is Redeemable at the Option of the Investor Should Be Considered an Equity Security or Debt Security	9/00	N/A	Not scheduled	Jacobs	Statement 155 did not address this Issue. Therefore, the FASB staff will bring this Issue to the Agenda Committee at a future meeting to determine whether to begin discussions on this Issue or to request that the Task Force remove this Issue from the agenda.	Future Agenda Committee Meeting